LONGMANS' COMMERCIAL SERIES

EDITED BY ALFRED NIXON, F.C.A.

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THE STUDENT'S AUDITING

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BY

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PREFACE

THIS book is designed for the examinations of the Institute of Chartered Accountants, and the Society of Accountants and Auditors, and also for clerks engaged in audit practice who desire some knowledge of this specialised branch of accountancy.

As a student, the author felt the need for a book which would serve as an introduction, and would be of assistance in reading the large works of the authorities on the subject, and this book has been arranged with that end in view. It is not intended as a substitute for the excellent works already published, but to assist the student in the early days of his training as an accountant, so that he may more properly appreciate the more detailed treatment of the subject which he will find in the more advanced treatises.

The auditor is frequently invited to advise on accountancy organisation and modern methods, consequently a chapter is included dealing with these important matters.

The cases mentioned will be found to be only those which should be most familiar to the student. References to the law reports have been purposely excluded, as it is thought that little will be gained by referring the student to matters which, in many cases, only lead to confusion of thought if approached without sufficient

knowledge of the subject. The student will find these references in the works above mentioned.

The author wishes to express his indebtedness to his former master, Alfred Nixon, Esq., F.C.A., for the valuable advice and assistance he has given in the preparation of the work, and also for permission to extract from Longmans' "Accounting and Banking" a number of the forms of account included in the last chapter.

HARRY E. EVANS

March, 1914.

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THE STUDENT'S AUDITING

INTRODUCTION

AUDITING—HISTORICAL

AUDITING, as it is known to-day, had its beginning with the growth of joint stock enterprise. Prior to that time it certainly existed but not to any great extent. Mr. Francis W. Pixley, in his work on "Auditors," gives us some interesting evidence of auditing in the pre-joint-stock period. In the early part of the nineteenth century, however, it was recognised that some form of auditing should be insisted on, and consequently we find various statutes making provision for the appointment of auditors of various classes of undertakings.

Whilst these enactments indicate that business men of the period recognised the need for auditors, they also indicate that they little realised the functions of the office; as witness the *Companies Clauses Consolidation Act*, 1845, which enacts that the auditors must be shareholders and that they may *employ an accountant.*

The next important enactment in connection with Joint Stock Companies was the *Companies Act*, 1862, which, though it did not provide for a *compulsory* audit, did provide in one of its Schedules a model set of articles

B

or rules (known as TABLE A) which contained rules for the appointment of auditors.

From that time various provisions were made for compulsory audit, notably of Banks, Building Societies, Friendly Societies, Industrial and Provident Societies, which in turn came in for various forms—effective and otherwise—of compulsory audit; but it was not until 1900 that the vast number of companies formed under the *Companies Act*, 1862, were attacked. The *Companies Act*, 1879, had made such companies—providing they were Banking Companies—liable to compulsory audit, and the *Companies Act*, 1900, extended the rule to all companies formed under the Companies Acts, 1862 to 1900.

The *Companies Act*, 1907, made the position of the auditor more independent and his duties more exacting.

The provisions of the Act of 1862 and subsequent amending Acts are now consolidated in the Companies (Consolidation) Act, 1908, the provisions of which, so far as they affect the subject, will be stated in another place.

Professional Accountants have kept pace with the progress of legislation. From 1854 to 1867, three Societies of Chartered Accountants were formed in Scotland; and in 1870 the Institute of Chartered Accountants in England and Wales was founded and was incorporated by Royal Charter in 1880. In 1885 the Society of Accountants and Auditors (Incorporated Accountants) was formed, and to-day the two societies represent practically the whole of Acccuntancy as a profession.

I

ACCOUNTING ORGANISATION

Importance of Organised Accountancy—Goods—Sales—Stock Accounts —Cash—Ledgers—Statements—Financial—Modern Methods.

THE modern business man realises the importance of organised accounting, and it falls to the lot of the professional accountant to organise systems of accounting for clients on commencing business, or to re-organise imperfect systems. A conscientious auditor will also be in a position to point out to his clients any defects in the system of accounting.

It is proposed to outline a system of accounting for an ordinary manufacturing concern; alterations and additions must necessarily be made in this system to meet the particular circumstances of each business—the intention being to indicate the general principles to be followed.

1. *Goods.*—All purchases should be authorised by printed and numbered order forms of which copies must be kept. All order forms to be signed by responsible officials specially authorised by the principal.

Invoices received must be compared with the order form and checked as regards—

(i.) Quantity and quality (by comparison with the Goods Inward Book).

(ii.) Price (by comparison with the Order Form).

(iii.) Extensions.

The persons responsible for each section of the work must initial the invoice.

In addition, it is recommended that some responsible official be appointed to see that the invoices are all fully checked. Invoices must be entered up in the Invoice Book and filed in the order of entry.

It will be found convenient to enter invoices weekly or monthly according to the usual pay days, as this will facilitate postings to the Bought Ledger; but where the number of invoices is very large, it will possibly be found necessary to enter them daily in order to avoid accumulation of labour.

Sales.—All orders received must be filed for reference. Invoices should be made out, copies taken, and forwarded on delivery of the goods. Delivery notes must also be prepared and signed by the customer or carrier for all goods sent out. Delivery notes must be carefully preserved, as they usually constitute the only evidence when it is necessary—as is frequently the case—to prove delivery of the goods.

The Day Book should be written up immediately the goods are dispatched.

Stock Books.—The importance of Stock Books cannot be too strongly emphasised. All goods received should be entered in a Goods Inward Book. This book should be checked with the invoices posted in quantities into a Goods Ledger. Goods used in manufacture should be sent out of stock on signed requisition notes, which

will be entered in a Goods Outwards Book. Sales should be similarly treated. The Goods Outwards Book should be checked with the requisition slips and the Sales Day Book to see that all goods outwards are charged to customers. In stocktaking it should be remembered that the actual stock in hand should be listed, and the stock list made and checked with the Stock Book. Small discrepancies will be written off where they can be accounted for by differences in weight, shrinkages or evaporation ; but large shortages of stock should be most carefully investigated, and not written off until a satisfactory explanation is forthcoming.

Where the business is of a purely factoring nature, it is possible to keep an efficient check on stock without the use of Stock Books.

The method (which is employed with great success in practice) is broadly as follows :—

(i.) Each parcel of goods inwards is given a number. These numbers are progressive. All invoices for goods received are entered in the Invoice Book in detail, the number of each parcel of goods being stated in the Invoice Book.

(ii.) On sale of goods, the Day Book is entered in detail giving the number of each parcel of goods.

(iii.) The Day Book and Invoice Book are then compared, and those goods which are sold (as shown by the numbers) are then marked as sold in the Invoice Book.

(iv.) The goods then remaining not marked off in the Invoice Book should represent the stock on hand, and if the closing stock is marked off in

the Invoice Book, any shortages will be revealed by a scrutiny of the Invoice Book, since any missing stock will not be "marked off" in the Invoice Book.

2. *Cash.*—The following rules are recommended in the treatment of cash—

(*a*) All cash received should be paid into the bank the same day.

(*b*) Counterfoil or carbon copy receipt book, specially printed and consecutively numbered, only should be used. The firm should state on all the *invoices* and *statements* that no other form of receipt will be acknowledged.

(*c*) Requests should be made to customers that they pay their accounts by cheques crossed specially to the firm's bankers.

(*d*) All monies received should be immediately entered in the Cash Book.

(*e*) The counterfoils should be checked with the received side of the Cash Book to see that all monies acknowledged are properly entered. All accounts above a fixed amount should be paid by cheque. Vouchers should be obtained for all payments, and should be numbered and filed in order of entry in the Cash Book; it is not advisable that the firm send its own form of receipt to be filled up by the payee.

Where the firm has its own form of cheque, the numbers of the cheques may be conveniently used as the numbers of corresponding receipts.

(*f*) No payment should be made until a statement

has been rendered, checked with the Bought Ledger, and discounted.

(*g*) Petty cash should be kept on the imprest system. By this method an amount called a "float" is advanced to the petty cashier sufficient to meet petty payments for a stated period. At the end of that period, an account of the total cash paid should be rendered to the cashier with all vouchers, who will then reimburse the petty cash clerk to the extent of the sums paid, thus restoring the "float" to the original amount.

(*h*) It is advisable that customers be requested to pay all accounts to the firm, and not to travellers. This rule is frequently inconvenient, indeed, in some cases extremely ill-advised. Under such circumstances travellers should be instructed to immediately remit all monies received by them to head office. They may be supplied with books of the firm's counterfoil or carbon copy receipts, the counterfoils being periodically compared with the travellers' remittance sheets.

On no account should the travellers be allowed to employ monies received by them from customers in paying their travelling expenses. Non-compliance with this rule is a heedless incentive to fraud, which is far more reprehensible than the actions of the many unfortunate travellers who have fallen into error on this account.

(*i*) Salaries should be paid by cheque, either a separate cheque for each salary or one for the

total. It is convenient to keep a Salary Book in which persons receiving their salary must sign on receipt of salary each month.

(*j*) Wages should be treated in the manner indicated in Chapter V.

The Bank Pass Book should be made up at frequent intervals and reconciled with the Cash Book. The bank interest and charges should be checked to see that the charges are in accordance with the arrangements at the bank.

The Ledgers should be kept up to date and balanced monthly on the self-balancing system. The cashier and clerks dealing with cash should not be allowed to post the Ledger, nor to take part in the rendering of the statements to customers.

Statement or Account Due Books should be kept, in which are entered details of the statements sent to customers, showing the amounts overdue together with particulars of settlement.

The following is a convenient ruling for monthly accounts.

Ledger folio.	Invoice, date of.	Statement when sent.	Name.	Address.	Amount.			Date when paid.	Amount.			Remarks.
					£	s.	d.		£	s.	d.	

Careful supervision should be kept and overdue accounts noted.

When the accounts are numerous a system of following up overdues should be introduced, and notes of applications for payments made in the Statement Book in the remarks column.

The overdue accounts should be periodically transferred, in order that they be not lost sight of by being scattered in various parts of the book amidst a large number of paid accounts, a note to this effect being made in the remarks column.

Orders received from customers should also have attention. It should be the duty of some responsible official to scrutinise these orders and refer to the customers' Ledger account before the goods are dispatched, the object in view being to keep the accounts within reasonable limits and thus prevent heavy bad debts.

This is a matter in which discretion must be used, as it will be seen that overcautiousness may be as dangerous as laxity, since the former will have the effect of stifling trade by driving away customers who are quite reliable within reasonable limits.

The statements received from creditors should be checked with the Bought Ledger immediately on receipt and differences inquired into and settled *with the creditor*. They should then be filed in convenient form so that all statements of unpaid accounts are made easily accessible, and that successive statements from the same creditor for the same debt are brought together.

Financial.—The cashier should always have regard

to the financial position of the company. He should endeavour to

(i.) Prevent violent fluctuations in the bank balance, particularly when the business is working on an account which fluctuates between a balance and overdraft.

(ii.) Arrange that the obligations of the business fall due at or shortly after the time the funds are expected to be received.

(iii.) Arrange that heavy obligations, *e.g.* on bills payable, do not fall due at the same time.

(iv.) Employ the resources of the business to the fullest advantage. It is unwise to retain a large bank balance, or indeed to keep down an overdraft when it can be safely increased, when the money can be employed in earning special discounts.

It is only by carrying out these recommendations that the office of a business can be made the real profit-making department which every section of a well-organised business ought to be.

Modern Methods

Probably the most debated points in connection with accountancy centre round the various modern methods which present themselves with such bewildering rapidity to the accountant.

The following matters will be dealt with :—

(1) Duplicating as a means of minimising the work involved in writing up books of first entry.

(2) Loose leaf and card ledgers.

(3) The slip system and use of vertical files in connection therewith.

(4) The typewriter as introduced into accountancy system.

(5) The extension of the scope of mechanical book-keeping by means of the Billing machine.

(6) Adding machines and calculating machines.

Duplicating.—The system of carbon copying is well known, but the full value of the carbon copies is not universally recognised. It has been found that these copies kept in book form will serve the purpose of a Sales Day Book, and also as Debit Cash Book. These have the advantage of giving an exact copy of the document sent to the customer and are a real labour-saving device.

On the other hand, openings for fraud have been alleged, and there is an increased risk of error by blurred and indistinct figures, but this can be reduced to a minimum if the carbon paper is frequently changed.

Loose Leaf and Card Ledgers.—The scope of these ledgers is not confined to the ordinary Purchases and Sales Ledgers, but extends to Stores Ledgers, Cost Ledgers and even to Nominal Ledgers, although a card Nominal Ledger cannot be seriously considered.

Loose leaf ledgers have many advantages, in particular may be mentioned—

(1) One account is kept in one part of the book and is not spread over several pages, as in a large heavy 1000 page ledger.

(2) Labour of opening new ledgers is saved.

(3) Old, dilapidated and worn out ledgers with loose and wayward leaves are entirely dispensed with.

(4) The system admits of convenient classification and grouping of accounts.

(*Note.*—It is not advisable to split up the ledger at statement time to facilitate the sending out of statements.)

To combat the risk of losing leaves and as a preventative against fraud it is suggested that—

(i.) A register should be kept of all the leaves.

(ii.) Leaves should be numbered and should be printed with the private mark of the firm.

(iii.) The stock of leaves should be in the custody of some responsible official.

(iv.) Ledgers should be locked and the keys kept by some responsible official.

(v.) Leaves taken from the ledger should be carefully noted.

It is advocated that the leaves removed from the ledger should be transferred to a transfer binder during the period in which they are likely to be required ; from thence they will be transferred to a box or case and stored away in the same way as old bound ledgers are disposed of.

Card Ledgers.—Much of what has already been said of loose leaf ledgers applies equally well to card ledgers. They are not, however, to be recommended as part of the financial system, but have found great favour as Cost Ledgers and for records of a statistical nature.

The main objections to them are that they are cumbersome and a very loose method of accounting. As adjuncts to the accounting system they have many advantages, but as a system itself they are not to be recommended.

It is suggested by many vendors of these systems that card ledgers are a great assistance at statement time, as being a means of facilitating the issue of statements. The method proposed is to remove all the cards from the trays and spread them all over the office.

Now this system cannot be too strongly deprecated. The risk of loss of cards will be obvious, whilst in addition the ledger clerks are given an opening of removing a burden from themselves and placing it on the shoulders of junior and probably inefficient clerks with unpleasant results.

The Slip System and use of Vertical Files in connection therewith.—This system is used by some firms having a large volume of small credit sales. The method adopted is to make out invoices, usually in triplicate. One copy is sent to the customer, another is carefully filed among the unpaid invoices, and the third, which remains stationary in the book, is added and the total used for posting to the sales account in the Nominal Ledger.

Turning to the unpaid invoices. These, as already mentioned, are carefully filed. Credits are similarly treated, being filed with the invoices, so that all current transactions with each customer are kept together in that customer's folder. When the invoice is paid a note to that effect is made on the invoice, which is then transferred to the paid invoice file, kept on the same system as that employed with the unpaid invoices ; all the filing should be done on the vertical system.

Mechanical Aids.—The typewriter is now commonly used in the making of invoices and statements, particularly those to which an adding machine is attached.

An improvement on the typewriter known as the Billing machine is used with considerable success in practice. This machine is particularly adapted to the needs of a business where a large number of documents are required all containing the same information. For example, the machine may be used to produce simultaneously:

Invoice.
Copy thereof.
Write up the Day Book.
Works instructions.
Delivery note.
Address label.
Heading for statement.

Adding and Calculating Machines.—Are useful as a check, particularly where a large number of items are to be treated. The adding machine is now used as an attachment to the typewriter and also to the Billing machine. In the latter machine two adding attachments may be employed, one to add the total of the invoice and the other to add the total sales.

The calculating machine may be used for adding, subtracting, multiplying and dividing, calculating percentages and foreign exchanges.

The principle of the machine is to decimalise all amounts in currency or measures such as cwts., qrs., lbs., and to work out with the aid of the machine the products, and then re-convert the answer, which is in decimal form to £ *s. d.* or whatever the answer may be.

II

AUDITING TO THE TRIAL BALANCE

Instructions for Audit—Audit Programmes—Ticks—Checking Postings—The Trial Balance—Location of Errors—Analysis of Subsidiary Books—Analysis of Ledgers—Sectional Balancing—The Continental System.

OUR client, Mr. A. Reader, commenced business twelve months ago on his own account, and at that time we advised him as to the methods he should adopt in keeping his accounts.

We therefore pay him a visit to ascertain the progress of the accounts and leave instructions for the preparation for the Audit.

These instructions were as follows :—

(i.) Postcards to be sent to creditors requesting them to forward " Stocktaking Statements."

(ii.) Bank Pass Book to be written up to date and Reconciliation Account prepared.

(iii.) Ledgers to be ruled off, balances carried down, and a schedule of Bad and Doubtful Debts prepared.

(iv.) A schedule of estimated amounts owing or prepaid in respect of such items as rent, rates, taxes, gas, water, electricity, commission, etc. to be prepared.

(v.) Stock to be taken. Proper lists being made, Extensions, Quantities, and Prices being certified by Responsible Officials.

(vi.) Trial Balance to be agreed, and draft Profit and Loss Account and Balance Sheet prepared.

At this visit we furnish ourselves with a list of the books in use together with the name of the clerks responsible for each portion of the work. We note as far as possible from a cursory examination, the standard of accuracy of the book-keeping. Careful inquiries are made in order to ascertain how far the system is being carried out and note any matters which it is thought desirable to pay special attention.

Having obtained this information we proceed to sketch the programme of the audit. All the circumstances must be carefully considered, for while it is essential that a complete investigation should be made, it is not always necessary to check the whole of the routine work—such as Ledger postings, Day Book additions and the like, since these can frequently be verified by a more expeditious method.

It is the custom of most accountants to embody the audit programme in an Audit Note Book, leaving a space opposite each item for the initials of the clerk or clerks engaged on the work, thus fixing the responsibility for errors on the clerk responsible therefor. The following is an example of a page of an Audit Note Book suitable for the usual annual audit.

P 1. CASH BOOK.	1912	1913	1914
Sales Ledger postings, checked by . .			
Bought Ledger postings, checked by .			
Nominal Ledger postings, checked by .			
Receipts vouched			
Payments vouched			
Bank balance reconciled			
Cash in hand counted			

Space should be provided in the Audit Note Book for notes and queries, in which should be systematically entered all matters which require further investigation, or on which comment should be made.

The Auditor's Tick.—There has from time to time been considerable discussion as to the form, style, and system of ticking entries. It is not proposed to continue here—what is at best an unprofitable discussion—but to suggest to the student those rules which it is thought are not open to criticism. They are :—

(i.) In the Account Books, the tick should be as clear and neat as possible.

(ii.) The colour of ink used should be of a special colour and changed at each audit.

(iii.) Each clerk should have a distinctive tick.

The first duty which the Junior is called upon to perform is that of checking additions. Attention is called to the importance of checking totals carried forward. As far as possible a section of the work should be completed at a sitting and a note made in the Audit Note Book of the totals. Where this is impossible note should be taken of the total at the point of ceasing work.

Checking Posting.—The extent to which postings should be checked is a matter which must be decided at each audit on the merits of the case. In a large concern having an efficient system of internal check it is obviously unnecessary to check all the postings. In such a case the auditor will be entitled to rely on the system, checking a portion of the work in order to see that the system is properly followed.

On the other hand, it is found frequently necessary

in practice to check a large volume of postings; in many cases the whole of the work is required to be checked.

It is advisable to work in an opposite direction to that followed by the clerk making the postings, *e.g.* postings from the Day Book to the Ledger should be checked from the Ledger to the Day Book. In this way the risk of making the same mistake as the clerk is minimised considerably. Of course it is necessary in such a case to examine the Day Books when the Ledgers have been completed to see that all entries therein are ticked. The necessity for speaking clearly will be apparent and in particular, the clerk should clearly make the distinction between such amounts as £40 2*s.* 6*d.* and £42 6*s.* 0*d.*

Two methods have been found in practice of coping with this difficulty—the one being to insert the word pounds after forty, as: "forty *pounds*, two and six," and the latter, to emphasise the last syllable of forty thus:—"for-*tie* two six." The former is to be commended as being more euphonious and decidedly clearer.

The Trial Balance and Location of Errors

On commencing the audit, the auditor is frequently informed that the books are not yet balanced, and he is requested to balance the accounts; and though this work may not strictly fall within the scope of the audit, it is frequently found advisable to conduct such a search. The principle to be followed will vary to a great extent with the system in vogue in the office. Dealing, however,

first with "get-there-quick" methods, we find the following suggestions :—

(i.) Check the additions of the trial balance itself.

(ii.) If the difference is a large uneven amount, compare the present with the trial balance of the preceding period, to see whether any item has been omitted or placed in the wrong column, or has the appearance of being unduly large or small.

(iii.) Differences of even amounts, such as £100, 10*d.* and so on, should be searched for in additions.

(iv.) Examine subsidiary books to see that all items are posted, particularly noting items of the same amount or half the amount of the difference. Note, however, that the right books are being examined, *e.g.* it is useless to expect to find a difference in this way by examining the Purchase Analysis Book for a difference in a Trial Balance, which is short debit.

(v.) Check both the opening and closing ledger Balances, for the period.

(vi.) The likelihood of a transposition of figures should be considered, *e.g.* a difference of 7*s.* 4*d.* would arise by posting 8*d.* as 8*s.* and *vice versâ.*

Care should be taken not to drive these hints too far as it is preferable to adopt more scientific methods. In an ordinary set of books it is usually possible to locate error and thus save a considerable amount of labour.

It is recommended (and indeed practised in most

accountant's offices) that adjustment accounts be prepared for the purpose of balancing separately the Sales, Bought, and Nominal Ledgers. The student must not confuse this with the more elaborate self-balancing ledger system, which cannot be employed without unnecessary labour, unless the books have been kept with that end in view during the period covered by the audit.

In sectional balancing it is necessary to analyse the subsidiary books. This is not nearly such a great labour as appears at first sight, the greatest difficulties being with the Journal and the payments side of the Cash Book.

In analysing the Sales Book it is necessary only to pick out those items posted to Bought or Nominal Ledgers, to subtract these from the Total, thus leaving a total which must be posted to the Sales Ledgers. A similar treatment will be meted out to the Purchase Book (here we pick out the Sales and Nominal Ledger items), the Returns Book, etc.

The analysis of the Cash Book is apt to cause considerable trouble. The same method as is applied to the Day Books, etc., may be also applied here, care being taken to see that all matters are considered; balances brought down being extracted as well as extraordinary items. The analysis of the debit side will therefore be obtained by extracting the Bought and Nominal Ledger items, and the opening and intermediate Balances brought down and the balance being postings to the Sales Ledger. On the credit side we should extract the Bought or Nominal Ledger Balances, whichever are the more convenient, and the Sales Ledger items and the intermediate and closing balances of cash.

The Journal must, as a general rule, be analysed item by item in order to ascertain the total debited and credited to each ledger.

Where transfers are made direct from one ledger to another these should be noted in extracting Ledger balances.

We have now in our possession the total amount debited and credited to each ledger, so that if we take the opening balances, *e.g.* of the Sales Ledger, debit the amounts obtained from the Day Book, Credit Cash, Journal Transfers, etc., together with the opening balances, and credit the amounts obtained from the Debit Cash, Returns, Purchases Books, etc., and the closing balances; we have an account which should balance.

Taking each section in this way it will be seen that the area of our operations is considerably reduced.

EXAMPLE

Assume our Trial Balance shows a difference of £24 short credit, and that the analysis of the books reveals the following figures:—

	Ledgers.		
	Sales.	Bought.	Nominal.
	£	£	£
Sales Day Books, postings to	15,007	25	3
Sales Returns Book, postings to	350	1	—
Purchase Day Book, postings to	16	13,782	7
Purchase Returns Book, postings to	3	1,005	1
Debit Cash Book, postings to (Opening balance, £1750)	14,105	8	66
Credit Cash Book (Closing balance, £780)	92	11,707	2350
Opening balances—Debit	3,115	85	3119
,, ,, Credit	70	1,125	5874
Closing balances—Debit	3,693	6	1172
,, ,, Credit	17	2,076	3534

The Adjustment Account would then reveal the difference as follows :—

Dr.			ADJUSTMENT ACCOUNT.			Cr.
Ledgers.			Particulars.	Ledgers.		
Sales.	Bought.	Nominal.		Sales.	Bought.	Nominal.
£	£	£		£	£	£
3,115	85	3,119	Opening Balances	70	1,125	5,874
15,007	25	3	Sales Day Book postings . .			15,035
		351	Sales Return Book postings .	350	1	
		13,805	Purchase Day Book postings .	16	13,782	7
3	1,005	1	Purchase Returns Book postings			1,009
92	11,707	2,350	Cash Book postings. . . .	14,105	8	66
17	2,076	3,534	Closing Balances	3,693	6	1,172
	24		Difference in Balance (as per Trial Balance).			
18,234	14,922	23,163	£56,319	18,234	14,922	23,163

TRIAL BALANCE.

	Dr.	Cr.
	£	£
Sales Ledgers Balances	3693	17
Bought Ledgers Balances.	6	2076
Nominal Ledgers Balances	1172	3534
Bank Balance	780	
Difference in balance		24
	5651	5651

It will thus be seen that the difference is in the Bought Ledger or in subsidiary book connected therewith.

Another method of localising errors is by analysis of the Ledgers. For this purpose we have sheets ruled after the following manner, the ruling being designed for a Bought Ledger.

Dr. Cr.

1.	2.		3.	4.			5		6.	7.
Returns.	Cash and Discount.	Particulars.	Other debits.	Closing balance.	Name.	Folio.	Goods.	Particulars.	Other credits.	Opening balance.

It will be seen that the columns 1, 2, 3, and 4 should equal columns 5, 6, and 7, any discrepancy will arise through incorrect analysing or extraction of balances. Further, the totals of columns 1 and 5 should equal the totals of the Purchase Returns and Purchase Day Book, after deducting postings from these books to other Ledgers.

Should these totals not agree, it will be apparent to the reader that there is an error in posting or addition of the subsidiary book under consideration. Columns 4 and 7 should agree with the total closing and opening Balances incorporated in the Trial Balances at the date of closing and opening the period respectively. Column 2 will agree with the analysis of the Cash Book, as explained above. The entries in columns 3 and 6 are not numerous in practice, but such entries should be noted in the particulars columns.

Example

Let us assume that we continue our search for the difference of £24 in the previous example, by analysis of the Bought Ledger, which we will assume for the sake of simplicity consists of six Ledger Accounts.

The reader will trace the figures in the imaginary analysis opposite into the Adjustment Account and find that all agree except the total of the Purchase Day Book £13,782, which is represented by £13,758 only in the analysis, which is our difference of £24.

The checking of the Postings and additions of the Purchase Day Book should reveal this difference.

Dr.										Cr.
Returns.	Cash and discount.	Other debits.		Closing balances.	Folio.	Goods.	Other credits.		Opening balances.
		Particulars.	Amount.				Particulars.	Amount.	
£	£		£	£		£		£	£
118	3,050	Sales Ledger Day Book, fo. 310 .	25	803	2	3,610	Sales Return Book fo. 31	1	385
407	1,979				25	2,380	Closing Dr. balance	6	
		Opening Dr. balance	85		33	77	Cash received, fo. 321	8	
210	1,922			425	35	2,237			320
270	4,518			848	45	5,216			420
	238				60	238			
1,005	11,707		110	2,076		13,758		15	1,125
		£14,898			Totals		£14,898		

The Continental System

This system of balancing, like most continental methods of bookkeeping, is extremely cumbersome. It has the advantage, however, of being very effective when properly worked, and for that reason has gained for itself a considerable amount of support in this country.

The trial balance is taken out in four columns, the two former, being for the *totals* of each account and the two latter being for the balance of each account. The accounts at the end of each year are all closed by a Journal entry and opened again at the commencement of the next year by an entry in the Journal similar to that made in opening a set of books for the first time. Subsequently every transfer is entered in the Journal as well as the totals of the Day Books, Purchase Books, and the total Cash received and paid, so that the total of the Journal will represent the total of the debits and credits in the books. It will be noted that this total should agree with the total of the first two columns in the Trial Balance inasmuch as the Trial Balance contains merely the same figures as those in the Journal except that they are taken from the Ledger.

Ruling of Trial Balance—(Continental Method).

Folio.	Particulars.	Totals.		Balances.	
		Dr.	Cr.	Dr.	Cr.

III

THE CASH BOOK

Objects of Audit of Cash Book—Additions and Postings—Vouching—Verification of Cash and Bank Balances—Bank Reconciliation.

ONE of the most important sections of any audit is the audit of the Cash Book. The entries should be verified with a view, not so much as to search for fraud, but rather to make it apparent to any person having opportunities for fraud, that you are sufficiently vigilant to discover any irregularity in the books should such arise.

Having this in view, you will readily see that no matter whether the amount of checking is great or small, so much as *is* done should receive your best attention, and should be completely and thoroughly done, in such a manner as to prevent the cashier or any other person manœuvring with figures which have already been checked.

The programme of the audit of the Cash Book would include—

(i.) Checking the additions and postings.

(ii.) Vouching the receipts and payments.

(iii.) Verifying the bank and cash balances.

Checking Additions and Postings.—It is advisable that all the additions be checked and that notes be

made of the totals that have been checked, and also of the total where the checking is left at an intermediate stage. It is also preferable to check all the additions on one page rather than to check one column for the whole of the period.

Where the postings are very numerous it may be possible to leave the postings, say, of the Sales Ledgers ; but it is recommended that the postings of the Private and Nominal Ledgers should always be checked.

Vouching.—Receipts should be inspected for the various payments made.

In scrutinising the vouchers it should be noted that the names, dates, and amounts are in order, and that they are properly stamped. Ordinary vouchers are preferable, from an auditor's point of view, to the payer's own printed form of receipt; but if it is the system of the auditor's client to send out with his remittances, his own form of receipt with a request that this be returned duly filled in instead of the usual form of receipt, the auditor cannot quarrel with the management of the business. This form of receipt is frequently found at the foot or back of the cheque.

It is the custom in some trades to dispense with receipts. In such a case, and if the auditor is aware of the custom, it appears that his duties in this direction must of necessity be less exacting, since he cannot require vouchers from the cashier where such a custom exists. He should, however, satisfy himself as to the existence of the custom, and should carefully scrutinise the invoices for the goods in respect of which the payment is made and also the accounts in the Bought Ledger to which this custom applies.

The entries in the Cash Book recording totals of wages, petty cash, postages, and the like, are vouched by comparing totals of the books transferred with the amounts entered in the Cash Book. Details as to the verification of these items will be found in another place.

Bank Charges will be vouched with the Bank Pass Book, Discount paid for collecting foreign bills will be checked with the banker's advices, and payment of bills will be vouched by the returned bills themselves.

The vouching of the Dr. side of the Cash Book is always a difficult piece of work. The Cash Book may be compared with counterfoil receipt forms, and this will provide some check, but one which, by reason of the opportunities for fraud which arise from counterfoil receipts, cannot be considered as satisfactory. Moreover, as this form of voucher does not come from an outside source it cannot be considered to be complete.

Reliable Vouchers for the Dr. side of the Cash Book are, *inter alia*, as follows,—

(i.) Counterfoil dividend and interest warrants.

(ii.) Banker's advices of payment of bills.

(iii.) Broker's notes of investments sold.

(iv.) The Bank Pass Book for deposits and interest receivable.

The vouchers and counterfoils as they are scrutinised should be cancelled by the clerk's initials. The cancellation should be plainly made, difficult, if not incapable, of erasure, and in such a manner that it immediately attracts notice, should the voucher be presented in support of more entries than one. Rubber stamps may be used for this purpose.

When all vouchers have been scrutinised, the Cash

Book should be examined and a list made of all vouchers that are missing. Those payments which are of such a nature that no receipt is available should be initialled by some responsible official and vouchers should be obtained for the remainder.

Verification of the Cash and Bank Balances

Wherever possible, the auditor should attend at the balancing of the Cash Book at the close of the period under review and count the cash in hand and agree the balance with the Cash Book. Where this cannot conveniently be done, he should attend as soon as possible thereafter and verify the balance at that date, having first vouched the Cash Book up to date.

Where there is more than one balance to be verified, *e.g.* a Cash and also a Petty Cash balance, they should be checked simultaneously in order that it may be impossible to produce one amount of cash in support of two balances. The same considerations apply where there is more than one establishment, but if there are so many branches, *e.g.* a large retail business with numerous shops and it is impossible to attend at all of them on the same day, arrangements should be made with the client enabling the auditor to pay surprise visits to verify the balances in hand at the various branches.

It frequently happens that the cash balance includes I.O.Us. In such a case the auditor should inquire into the circumstances of the case, and trace through the books the subsequent entries bearing out the statements made to him.

EXAMPLE

I am the auditor of the A. B. Co. An I.O.U. for £10, signed John Jones, is included in the Cash balance. On inquiry I am informed that Jones is a traveller and was advanced £10 in connection with a journey to Ireland which commenced a week before stock-taking. In such a case it would be necessary to trace the entry in the Cash Book, subsequent to stock-taking, recording Jones's expenses and inspect Jones's receipt for the sum, also see that a reserve is made in the accounts to cover the expenses for the week prior to stock-taking.

In the case of *London Oil Storage Co., Ltd.* v. *Seear, Hasluck & Co.*, the auditors were held liable in damages sustained by their clients through defalcations by the cashier, which would have been discovered, and the losses correspondingly reduced, had the auditors called for the production of the petty cash balance, which at the date of the discovery of the fraud amounted to over £700.

Verification of the bank balances consists of comparing the Bank Pass Book with the Cash Book.

So many of the cheques should be traced into the Pass Book as are necessary for the preparation of a Reconciliation Statement, and all the deposits should be checked with the Bank Pass Book. The Reconciliation Statement is necessary, since it is unlikely that the balance as per the Pass Book will agree with the balance as shown in the Cash Book, the reason being that cheques which have been entered in the Cash Book may not have been presented for payment and deposits may not yet have been credited by the bank.

The statement will therefore show all the adjustments which are necessary to agree the two amounts.

Example

Let us assume that the balance at the bank, as per the Cash Book, at June 30th, 1912, is £400, which includes a deposit on June 30th of £250 and two cheques sent on June 30th, one to Robinson for £100 and another to Jones for £120, none of which have yet been entered in the Pass Book, then the Pass Book will show a balance of £370.

The Reconciliation Statement will be as follows:—

Bank Reconciliation Statement,

June 30th, 1912.

Balance as per Cash Book . . .		£400 0 0
Deduct deposit, not credited by bank, June 30th		250 0 0
		150 0 0
Add unpresented cheques		
Robinson . . .	£100 0 0	
Jones.	120 0 0	
		220 0 0
Balance as per Pass Book . .		£370 0 0

The auditor should also obtain from the bank, a confirmation of the balance as shown by the Pass Book. This may be done in two ways:—

(i.) By writing to the bank asking them whether the balance as shown by their books agrees with

the balance as shown by the Pass Book. The amount of the balance must be stated in this letter.

(ii.) By taking the Pass Book to the bank in person and requesting a verification of the balance.

IV

JOURNALS

Use of Journal in Practice — Audit — Vouching—Purchase Journal—Examination of Invoices—Purchase Returns Book—Day Books—Bills Books.

THE term Journal in its broadest sense includes any book in which transactions are recorded from day to day, so that a Day Book or Invoice Book will fall within the term Journal. A Journal in which the debit and credit for each transaction are stated is seldom used in this country. There are a few accountants, however, who prefer to write up all transfers and all totals of the subsidiary books and the total of the Cash Book in the Journal with a view of balancing on the continental system. In practice the Journal is either for transfers and private entries which cannot be conveniently entered elsewhere, and is frequently entirely dispensed with.

Where the Journal is in use it will be seen that its nature is such that it will require careful attention. The postings should be checked, and the additions if these have been made. Where the Journal is not added, the items should be scrutinised to see that the debit and credit columns agree.

The entries in the Journal should be supported by vouchers. In some cases this is of course impossible, and indeed unnecessary, whereas indirect evidence only is available in other cases. The auditor must use his own discretion, but must not lose sight of the fact that the

Journal is a convenient agent for removing inconvenient balances.

The following are suggested as Vouchers for the more common forms of Journal entry :—

I. Bad Debts written off

(*a*) Notices of Bankruptcy and receipt of a final dividend.

(*b*) Notices of deeds of arrangement.

(*c*) Notices of liquidation of companies.

(*d*) Letters from solicitors *re* proceeds of executions, results of proceedings or prospects of recovery.

II. Transfers from one Personal Account to Another

(*a*) Transfers made on instructions from agents or customers, and should be supported by correspondence.

(*b*) Transfers made to correct errors—the original entry should be traced.

III. Transfers from one Impersonal Account to Another

The reason for the transfer should be inquired into, the documents supporting the original entry, if any, should be re-inspected—to see that they accord with the accounts as amended by the transfer.

IV. Minutes of Directors

These will be useful to vouch for—

(*a*) Issue of Shares or Debentures.

(*b*) Forfeiture of Shares.

(*c*) Payments of Dividends.

V. Profits and Losses on Consignments

May be indirectly vouched by inspection of Accounts Sales from agents, to see that all goods shipped under the consignment are duly accounted for in the Accounts Sales.

VI. Bills returned Dishonoured

Will be a sufficient voucher for the entry, re-debiting the person from whom they are received. Where this has been surrendered the cash received should be traced through the books.

Where there is no voucher available the effect of the entry should be carefully considered and the auditor must satisfy himself by inquiry into the circumstances giving rise to the entry.

Purchase Journal or Invoice Book

Should be checked with the invoices. Attention is called to the following points in connection with the examination of invoices.

(i.) *Invoices should be made out to the client.* Any practice whereby the names of employés are substituted for the name of the firm is to be condemned.

(ii.) *The date of the invoice* should be within the period covered by the accounts.

Where invoices bearing a date prior to the period of the accounts are included—the reason for their exclusion from the previous period figures should be inquired into with a view of ascertaining—

(*a*) Whether they are *bonâ fide* charges or merely inserted to cover errors or defalcations; and,

(*b*) Whether the goods comprised in the invoices were correctly treated in the previous stock-taking.

(iii.) The goods comprised in the invoice should be of such a nature as may be reasonably expected in such a business.

(iv.) The invoices should be checked as regards quantities, prices, and extensions, the clerk responsible for each, initialling the invoice. The whole of the invoices should then be passed by some responsible official or officials.

(v.) The analysis of the invoices should be inspected with particular reference to invoices for Capital additions, and it is recommended that these be re-examined when the general examination is completed; careful note being made of the nature of the additions as revealed by the invoice.

(vi.) Trade discounts should be deducted from all invoices before they are entered up in the Purchase Journal. Where cash discounts are obtained on invoices for Capital purchases, such discount should also be deducted from the invoice.

(vii.) Each invoice when examined should be cancelled by a clear and bold tick, initial or stamp. The cancellation should be sufficiently clear and prominent to render it impossible to again present that invoice in support of a subsequent entry.

When all the invoices have been checked into the

Invoice Book, the latter should be examined and a list made of all invoices missing. These should be searched for by the staff, and if necessary copies obtained.

Purchase Returns and Allowances Book

Should be checked with the credit notes. The entries in the books should be scrutinised with care, particularly the analysis columns. The postings to the Bought Ledger should be checked, notes being made of allowances and deductions which have not been claimed at the proper date of settlement. The cause of these irregularities should be inquired into with a view of ascertaining whether the allowances debited in the ledger represent *bonâ fide* claims.

In a well-managed business, the items appearing in this book will be few in number with the exception of those which are incidental to that particular business, *e.g.* firms sending cloth to bleachers or dyers can expect to have to make frequent claims in connection with cloth "damaged and kept" and "shorts." In consequence the auditor will be able to pay close attention to each item in this book.

Sales Day Books and Sales Returns and Allowance Books

It is not usual to vouch the entries in the Sales Day Books, but if desired the Delivery Notes may be used for this purpose. This proceeding, however, is not recommended unless there is some special object in view (see p. 46).

The postings to the Personal Accounts should be checked either by calling over or by totals, and the auditor should regard with suspicion any entry in the Day Book to balance an account. Such entries are evidence of weakness in the system, and as such should be carefully investigated.

The Sales Returns and Allowances Books should receive very careful attention. The entries should be supported by the written claims of customers, and the whole certified by some responsible official.

Bills Receivable and Payable Books

In practice we find two forms of Bill Book :—

(i.) A book which is purely one of record, in which the details of the bills are set out and posted to the Personal Account, and the total posted periodically to the Bills Receivable or Payable Account, as the case may be.

(ii.) A book in which the bills are entered and posted to the Personal Account as before, but possessing additional columns in which is posted from the Cash Book, the amount of cash paid or received at settlement.

This book then becomes a Ledger Account, since no totals are posted.

An example of a Bills Receivable Book of the latter type is given with illustrative entries.

The auditor should check the postings of this book, vouch the entries in the discount column with the bank advices, check the additions and balances down, and verify the balances in the manner indicated in Chapter VI.

EXAMPLE OF BILLS RECEIVABLE

Dr.

No.	Date received, 1913.	From whom received.	By whom drawn.	Date.	On whom drawn.	Where payable.	Tenor.
1	Jan. 4	J. Brown	Self	Jan. 1	J. Brown	Parr's Bank, Manchester.	3 mo. date
2	Feb. 6	J. Brown	J. Brown	Feb. 1	S. Turner	L. C. & M. Bank, London.	3 mo. date
3	Mar. 4	A. Smith	Self	Mar. 1	A. Smith	Lloyds' Bank, Manchester.	6 mo. date
4	Mar. 6	J. Brown	Self	Mar. 1	J. Brown	Parr's Bank, Manchester.	3 mo. date
5	April 4	J. Brown	Self	April 1	J. Brown	Parr's Bank, Manchester.	3 mo. date
	June 30	Balance	brought	down			
3	Mar. 4	A. Smith	Self	Mar. 1	A. Smith	Lloyds' Bank, Manchester.	6 mo. date
5	April 4	J. Brown	Self	April 1	J. Brown	Parr's Bank, Manchester.	3 mo. date

BOOK WITH CREDIT COLUMNS.

Cr.

When accepted.	When due.	Ledger folio.	Amount.			When and how disposed of.							
						Date.	Folio.	Cash.			Discount.		
			£	s.	d.			£	s.	d.	£	s.	d.
Jan. 4	April 4	36	250	0	0	April 4	12	250	0	0			
Feb. 4	May 4	36	250	0	0	Feb. 4	8	246	17	6	3	2	6
Mar. 2	Sept. 4	41	300	0	0								
Mar. 3	June 4	36	250	0	0	June 4	16	250	0	0			
April 2	July 4	36	250	0	0								
			1300	0	0			746	17	6	3	2	6
								3	2	6			
						June 30	Balance carried down	550	0	0			
		£	1300	0	0		£	1300	0	0			
Mar. 2	Sept. 4		300	0	0								
April 2	July 4		250	0	0								
			550	0	0								

V

THE REVENUE ACCOUNT

Forms of Revenue Account—Trading Account—Manufacturing Account —Purchases—Sales—Wages—Profit and Loss Account—Audit of Items appearing in the Profit and Loss Account.

THE term Revenue Account is used to cover the various classes of accounts made up with the object of disclosing the amount of profit made or loss suffered by an undertaking, and how profit or loss has arisen.

This account varies considerably in form, and includes—

(i.) The Trading and Profit and Loss Account of a trading concern.

(ii.) The Manufacturing and Profit and Loss Account of a manufacturing concern.

(iii.) The Income and Expenditure Account of an institution or society; but not a Receipts and Payments Account.

(iv.) The Revenue Accounts of statutory companies and of companies whose income is derived from sources otherwise than trading and manufacturing, *e.g.* investment companies.

In this chapter we will confine ourselves to the Trading, Manufacturing, and Profit and Loss Accounts,

the Income and Expenditure and Revenue Accounts being considered later.

The Trading Account shows the gross profit on trading as distinguished from manufacturing.

The following example will serve to show the contents of an average Trading Account.

TRADING ACCOUNT

FOR THE YEAR ENDING DECEMBER 31ST, 1912

Dr.	£	£		Cr. £
1911.			1912.	
Dec. 31. To stock on hand		4,500	Dec. 31. By sales . . .	32,500
1912.			,, stock on hand	5,000
Dec. 31. To purchases .	25,200			
,, carriage inwards . .	800			
		26,000		
,, balance (being gross profit carried to Profit and Loss Account) . .		7,000		
		37,500		37,500

The Manufacturing Account shows the cost of production of a manufacturer together with the proceeds of that which is produced, the balance being the gross profit or loss.

The following example should be compared with the above Trading Account, and the peculiarities of each noted.

YARN MANUFACTURING ACCOUNT

For the Year ending December 31st, 1912

Dr.					Cr.
1912.		£	£		£
Dec. 31.	To cotton (including brokerage and charges)	75,000		By yarn	99,000
	,, carriage	1,000		,, waste	2,000
			76,000		
	,, fuel		2,000		
	,, oil and tallow and general stores		300		
	,, wages (productive)		14,000		
	,, balance (gross profit carried to Profit and Loss Account)		8,700		
			101,000		101,000

In the above Account the actual amount of goods used or produced, as the case may be, is included.

The Cotton Account is herewith given as an example to illustrate the method of ascertaining these figures:—

COTTON ACCOUNT

Dr.					Cr.
1911.		£	1912.		£
Dec. 31st.	To balance (Being stock on hand brought down.)	22,000	Dec. 31st.	By Manufacturing Account	75,000
1912.				By balance (Being stock on hand.)	24,000
Dec. 31st.	To purchases	77,000			
		99,000			99,000
	To balance (Brought down.)	24,000			

The opening stock should be compared with the last audited account to see that they coincide. If the business be a new one this item of course will not appear, and if the business is taken over, *e.g.* by a company from a private concern, then the opening stock will be included at the valuation at which it was taken over from the vendor of the business.

Purchases of Goods.—Goods here include those used in the manufacture and should *not* include purchases for improvements in plant and machinery.

The figure will be verified during the course of the audit by checking invoices to the Purchase Day Book or Invoices Analysis Book and postings in the Bought Ledger. The total of the Purchases Day Book is posted to the Nominal Ledger, and from thence transferred to the Trading Account.

Carriage.—This amount includes carriage *inwards* on purchases only, and is added to the cost of production, being part of the cost of goods. Carriage *outwards* on sales is a cost of distribution, and should be brought into the Profit and Loss Account.

Where materials are shipped from abroad, this item will include freight, insurance and other charges on the goods.

Fuel.—The cost of power, whether it be coal, oil, gas or electricity, should be added to the cost of manufacture. Care should be exercised to see that power only is included in the Trading Account; lighting, etc., being charged to Profit and Loss Account.

Sales

The postings of the Day Books to the Sales Ledgers will be checked either by calling over or by totals.

The sales credited to Trading Account should be sales of *goods* only. Sales of plant or old office furniture and the like should be credited to the particular account affected, and *not* the Trading Account.

It must be noted that only actual sales are to be taken to Credit: goods sent "on approval," or "sales or return," not being credited as "sales" until actually accepted by the purchaser.

Attempts are frequently made to increase sales for a period or by improper means.

The auditor should pay attention to the books with a view to detecting fictitious or improper entries, particularly towards the end of the period covered by the accounts.

Two common examples of this kind are given.

(i.) The inserting of entries entirely fictitious.

These will be found difficult to discover when made towards the close of the period. If, however, they are made at an early date—the fact that they are not paid should give rise to suspicion when the Sales Ledgers are checked.

Where they are made towards the end of the period they will not usually be discovered, unless the *turnover for the* LAST *month* is so much inflated as to cause suspicion to be aroused. In such a case the auditor should inspect Delivery Notes of at least the largest items of sales, unless, indeed, a satisfactory explanation is forthcoming.

In no case, however, should great reliance be placed on Delivery Notes, the manufacturing of fictitious ones being a simple matter.

The auditor must be guided by all the facts of the case, not by the result of a merely mechanical check.

(ii.) Wilfully *dating* entries incorrectly with a view to bringing into the old period, sales which in reality belong to the new period.

This must of necessity happen at the end of the period, and consequently no question can arise, unless the amount is sufficiently large to call for investigation, in which case checking of Delivery Notes with SPECIAL *attention to the dates* may reveal the fault. The importance of the caution given above will be greater, as here it will be seen that the alteration or apparent mistake merely of the date will be sufficient to break through a mechanical check.

Goods on Consignment

Should not be treated as *sold* until actually sold. Goods remaining out on consignment at the date of stock-taking being treated as stock and valued at cost.

Wages.—The Trading Account should only contain the amount of productive wages; cost of distribution and office being a charge to Profit and Loss Account.

It is usually impossible to verify this item in detail; reliance must be placed on the system of internal check.

Where the system of pay is by piece work, a fairly reliable test may be obtained in this way :—

(i.) The proportion of wages paid to production should not greatly vary from year to year without proper explanation of the difference being forthcoming; and

(ii.) A comparison of these percentages should be made from year to year.

(iii.) Some portion of the Wages Books should *always* be checked and a general scrutiny

made; notes being taken of matters which call for inquiry; and in view of the great opportunities for fraud in this direction, this should be as thorough as circumstances will permit.

The system should leave no loophole for fraud or provide a means of preventing collusion.

The following general rules are suggested:—

(i.) The foremen should certify the time worked, or amount of piece work done by the men under their control.

(ii.) Calculations should be made by one clerk and checked by another.

(iii,) A cheque should be drawn for the actual amount of the wages, and the money received from the bank by the cashier, and wages actually paid by him or by a clerk who has not been previously connected with the work.

It is usually necessary to reserve for wages paid for the week in which the accounts are made up. *E.g.* if the date of the Balance is Wednesday, April 30th, 1913, and wages are paid up to Thursday night, a reserve will be made for the wages accrued from the previous Friday morning to Wednesday night, *i.e.* 4½ working days.

The general accuracy of the Trading and Manufacturing Accounts can be judged by a comparison of percentages for the period under review with those of the previous years. Taking the ordinary merchant's Trading Account, the percentage of gross profit to turnover should not greatly vary from year to year unless good cause is shown for the fluctuation.

In the case of manufacturing, the percentages of the

various costs of manufacture to production might be advantageously compared with previous years and marked fluctuations, if any, thereby revealed should be the basis of careful inquiry by the auditor as to the cause—for cause there must be,—and the information obtained should be tested to see whether it accounts for the discrepancy.

The Profit and Loss Account is the continuation of the Revenue Account, and contains all those items of Revenue which are not connected with the cost of production or gross profit.

The following is an example of the usual form of Profit and Loss Account for a sole trader :—

PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDING DECEMBER 31ST, 1912

Dr. Cr.

		£			£
1912. Dec. 31.	To salaries and wages	1000	1912. Dec. 31.	By gross profit from trading account .	7000
	,, rents, rates and taxes . . .	400		,, discounts received . .	1000
	,, carriage . . .	100			
	,, interest on loans .	500			
	,, income tax . .	50			
	,, trade expenses .	350			
	,, commissions . .	850			
	,, discounts allowed	1600			
	,, travelling expenses	600			
	,, advertising and catalogues . .	1000			
	,, balance, net profit carried to capital account .	1550			
		8000			8000

Salaries and Wages.—Under this heading we find the salaries and wages of the office Staff, managers, etc.

The auditor should inspect the Salaries or Office Wages Book, noting new appointments and advances of salary. It is advisable that clerks be requested to give a memorandum receipt for their wages. For this purpose it is convenient to keep a Salaries Book with a folio for each clerk in which he signs week by week for the wages paid to him, the amount each week being written opposite his signature. Where necessary a reserve for salaries and wages accrued to the date of the balance sheet will be made in the manner explained under the heading of "Wages."

Rent, Rates, and Taxes.—The auditor should compare the items in this class with the previous year, noting any new charges and inquire into the circumstances giving rise to them.

Calculation of reserves for amounts owing and prepaid is an important matter, and the auditor should take care to see that all reserves have been duly made. Similar considerations will apply to insurance premiums.

It should be noted that the correct amount payable under an Employer's Indemnity Policy against workmen's compensation risks can be ascertained by reference to the actual amount of wages paid. A percentage on this figure is usually the amount charged by the insurance company; consequently the amount payable in any one year will be the proper charge to Profit and Loss Account; the balance being prepaid or reserve, as the case may be.

Fees Payable on Renewal of Patents will be treated by the auditor in a similar manner.

It should be noted here, however, that on an *English*

patent, *fees* do not become payable until the fifth year of the patent, and thereafter increase £1 per annum until expiry, so that in comparing previous years the auditor will have regard to these facts.

Carriage.—This item will consist of carriage *outwards* on sales; carriage inwards on purchases having been charged in the trading account. As carriage is a fruitful ground for petty fraud, the auditor should pay special attention to vouching—particularly petty cash payments under this head; detailed checking is impossible. The auditor must rely on the system of internal check and if possible get some responsible official to pass all these payments as correct.

Interest on Loans.—The auditor should see that all Loan Accounts are properly credited with interest; that income tax is deducted before payment, and that all interest not charged up to the date of the balance sheet is reserved for.

Dividends and Interest Receivable.—Where dividends and interests are due on shares, stocks, mortgages or loans, which are the property of the client, each investment account should be inspected to see that all income is brought to credit. Interest should not, however, be allowed to accumulate on loans irrecoverable, and where payments of interest are in arrear the auditor should inquire into the circumstances.

Income Tax.—The auditor should see that all income tax chargeable in the accounts is properly included under this head.

In practice this is seldom the amount of the income tax demand, nor is it this figure adjusted by reserving for the proportion prepaid.

Income tax deducted in paying chief rents, interest, and similar items should be credited to this Income Tax Account, and the gross amount of the sum payable debited to the appropriate account. Similarly Income Tax deducted from income receivable should be debited ; the full amount of the income credited to the Income Account.

Care should be taken in estimating the amount of income tax owing, or prepaid, as the case may be. The amount of income tax deducted from annual charges outwards is a liability and should be so treated in the accounts. But income tax deducted from income receivable should be charged to the Profit and Loss Account, since the amount of the income itself is credited.

In calculating the proportion of the income tax demand, prepaid or owing, at the end of the financial year, it is necessary to deduct from the demand the amount of the tax deducted from annual charges.

The importance of these considerations will be apparent from the following example.

Example

A, B, & Co. are assessed at £2,400 for the year 1912–13, and pay interests, etc., on chief rents, from which they deduct tax before payment of £1,200. They also receive dividends and interests amounting to £300 gross. The firm makes up its accounts to December 31st, 1912, and has not charged the income tax demand in its accounts.

The Journal entries will therefore show in respect of these transactions :—

	£ s. d.	Dr. £	s.	d.	Cr. £	s.	d.
Interest. Chief rents, etc., account .		70	0	0			
To Income Tax Account . . .					70	0	0
(Being amount of Tax deducted before payment of interest, chief rents, etc.)							
Income Tax Account		17	10	0			
Dividends and interest receivable					17	10	0
(Being amount of Tax deducted from dividends and interest receivable.)							
Income Tax Account		121	15	7			
To Income Tax Reserve . . .					121	15	7
(Being amount of reserve for income tax owing as follows :							
Amount of tax deducted and not accounted	70 0 0						
Amount of demand £140, less tax deducted £70 = £70 apportioned 270 days owing)	51 15 7						
	£ 121 15 7						

Trade Expenses.—Under this heading we find all those miscellaneous items that are a proper charge to the business.

The auditor should scrutinise the items to see that no charges are made to the business which are in the nature of private expenses.

It is always advisable to keep this account to a reasonable amount and to exercise care in debiting items to it.

It is often found in practice that in this account are included many items which it would be better to place under special headings. This should be avoided by opening a separate account where there are large and

numerous items of the same class, for though undue multiplication of accounts is not to be recommended, still in this case, at least, we should endeavour to bring expenses under their proper headings, such as Office Expenses, Stationery, and the like, rather than the unsatisfactory term of "Trade" or "General" expenses.

We frequently find annual charges such as telephone rents and Stock Exchange subscriptions included in this account. The auditor should in such a case see that provision is made for the proportion prepaid or owing as the case may be.

Commissions.—The auditor should inspect all agreements with travellers and agents with regard to payment of commission, and see that the commission paid is at the rate and on the amount allowed in the agreement.

Vouchers will of course be produced for the actual commission paid, so that the account will not be charged with sums other than those actually paid (subject to reserves); but the auditor should exercise special diligence to see that the amount is not unduly large, having regard to the usual rates paid in the trade and the amount of business done.

The question of reserves for commissions owing is one requiring careful consideration, inasmuch as the amount of the reserves is comparatively large and reliable information not infrequently only obtainable some time after the accounts have been made up.

The turnover on which commission is payable must be carefully estimated, and the auditor should verify this amount by references to previous years' reserves and the amount of business done during the period covered by the accounts. Payments on account of commissions not

yet ascertained should be debited to the traveller or agent and the amount reserved shown as a credit in the books as: "Reserve for commissions outstanding;" but in the Balance Sheet it is preferable that the one item be set off against the other, and the net figures debit or credit be shown only, under the heading amounts prepaid or owing, as the case may be.

Where commission is payable only on payment for the orders received, it should be noted that a reserve must be made for the commission on accounts outstanding as well as on the accounts paid for which commission has not been credited. The former amount may be roughly checked by calculating the approximate accounts which should be outstanding, based on the usual terms of credit and the average turnover.

Discounts Allowed.—The auditor will in the course of checking the Cash Book postings note any discounts allowed in excess of the usual trade terms. As this account provides ready means of concealing fraud, care should be taken in this department of routine work, and the auditor should inquire into the circumstances of all irregular allowances of discount.

The discount included under this heading is the cash discount allowed on payment of accounts and should not include:—

(i.) *Trade Discount*, which should be deducted from the Sales in the Trading Account.

(ii.) Discount on bills charged by bankers, which should be charged to Discount on Bills Account.

The custom of showing the balance only of the discount in the Profit and Loss Account, *i.e.* the difference

between discount received and discount allowed is not to be recommended. The custom conveys no idea of the benefit and loss occasioned by credit or the value of ready money as reflected in the amount of discount received or the loss incurred on discount allowed.

It is advisable that a reserve be made for the amount of discount on debit balances outstanding.

Two methods are adopted in practice—

(i.) Taking a percentage of the total debtors.

(ii.) Estimating the amount of discount which must be allowed on each individual balance, and reserving the total.

The former has the advantage of the argument of expediency, and though unscientific is just as likely to be near the true amount as the latter, provided reasonable care is exercised in fixing the percentage. The latter method, however, is recommended where rates of discounts vary considerably.

Discounts Received.—Beyond a careful scrutiny of the vouchers for payments the auditor can do little towards verifying this item, and indeed a good system of audit will provide an automatic check on this item.

It is quite legitimate to anticipate profit from discounts on accounts outstanding and a provision should be made for this amount.

Packing Expenses.—This amount usually contains the cost of packing together with the loss on empties. The cost of packing will be verified by reference to the invoices for materials supplied.

When dealing with empties, the system of charging packages should be inquired into. Where it is the custom to charge packages to the customer and to credit

returned empties, the Ledger balances should be taken out in two columns distinguishing goods and packages, so that the latter may be discounted at a rate sufficient to reduce the balance sheet value to cost.

As this is a department in which there is not infrequently considerable slackness, a simple system should be in use in every business where empties occur. It is suggested that :—

(i.) All packages charged on invoices inwards be analysed into a column of the Purchase Analysis Book specially provided for the purpose. Returns should be similarly treated.

(ii.) The Bought Ledger should have columns on debit and credit for packages in which all returnable packages charged and empties returned should be entered; these columns should form part of the double entry and not memoranda.

(iii.) The packages charged outwards and returns inwards on sales should be treated in same manner as packages on goods inwards.

(iv.) The totals of packages received and charged out should be posted to a packages account. This account, when adjusted by adequate reserves and by stocks on hand, will represent the loss on empties, which will be charged to Profit and Loss Account.

Travelling Expenses.—Care must be exercised to see that all expenses debited are in fact chargeable.

Travellers' expenses slips should be initialled by some responsible official before payment is made by the cashier. When travellers have received advances—*e.g.*,

for a journey abroad, the journey being still in progress at the date of the balance sheet—it will frequently be found advisable to charge a portion only of the expense to the Travelling Expenses Account.

Where travellers receive advances in this manner they should be debited with it to a personal account and credited when the journey is completed and their expenses settled.

Advertising and Catalogues.—In many businesses this item is amongst the heaviest of the expenses. Dealing with advertising the auditor will pay attention to the advertising accounts and ascertain as far as possible that all advertising has been charged in the accounts.

The verification of the expenses on catalogues is simple, but not infrequently the auditor is faced with rather delicate problems. In businesses where a large and elaborate catalogue is essential, the initial cost of one issue is so heavy that to charge the whole in one year would be disastrous, and indeed incorrect, as in many cases the supply, or at least that issue reprinted, will last three to five years. In such a case the expenditure may be kept in suspense and written off over the estimated life.

Care should be taken that where the catalogues on hand are included in the stock, that the total of the stock of catalogues is either deducted from the suspense account or eliminated from the accounts. Similar considerations will apply to an advertising campaign.

The advertising expenses of putting a new article on the market is frequently kept in suspense and even treated as goodwill, though there can be no justification for the latter practice. The effect of advertising is bound

to diminish, and this should be reflected in the accounts. Moreover, the retention of paper assets in the balance sheet is usually considered evidence of weakness.

Bad Debts should always receive the careful attention of the auditor. Documentary evidence should be produced for all debts written off as bad. These will include:—

Notices of Bankruptcy, Deeds of Assignment, Liquidations and other documents showing the irrecoverable nature of the debt.

A reserve should be made for bad and doubtful debts, where the debtors are numerous or their financial standing doubtful. The amount is in practice taken as a percentage of the balances or the sales of the period, or estimated on each balance and the total deducted from the debtor balances.

Royalties, Mining and Colliery Accounts

The sum to debit to revenue will be the amount of royalty payable on the tonnage raised plus the amount of irrecoverable short workings.

The rate of royalty may be ascertained by reference to the lease and from this can be obtained the amount of royalty which should be paid on the output.

The amount of irrecoverable dead rent is a matter which will require careful investigation. Where the lease does not provide for the recovery of short workings, the accounts will bear the amount of the minimum rent or royalty payable, as the case may be. Further, where the time allowed for recovery of short workings has expired, then if they are not recovered they should be immediately written off to Revenue. Where, however, the short

workings by the agreement are recoverable, we must consider the problem of the prospect of the output being sufficient to clear the minimum rent plus the short workings, as it would be wrong in principle to pile up short workings in the balance sheet.

Where there is no reasonable prospect of their recovery each case must be considered on its merits ; but it is suggested that if the output of a mine has not reached the minimum rent by the time it is in full working, then no further additions should be made to short workings, the whole of the minimum rent charged to Revenue and the question of writing off the short workings already accumulated, considered.

Patents and Copyrights

The accounts must be charged with royalties on the sales for the period under review, that is the amount already credited to the owner of the patent or copyright plus a reserve for the amount due on sales effected since the date of the last account to the owner or patentee.

Generally the auditor should see that payment of royalties are in accordance with leases or agreements, are properly vouched and reserves provided for royalties which have accrued since the last settlement of accounts.

Royalties should be paid less income tax, and the auditor should see that this is properly treated in the account.

Conclusion.—The more usual items appearing in a trader's Profit and Loss Account are given above. Matters affecting particular classes of accounts are

discussed with other matters affecting their particular class.

The subjects of Depreciation and Reserves will be found in a later chapter.

Coming now to a general consideration of the Profit and Loss Account. The auditors should always compare the items with previous years' accounts and should note and carefully inquire into all exceptional changes. To this end it is advisable that a careful analysis of expenses placed under their proper headings be made.

The object in view should always be to show clearly the actual profits of the business.

Whether the client be a sole trader, a partnership, or corporation, the auditor should protest against erroneous accounts; whether they be overstated or understated is immaterial, the fact that they are incorrect should be a sufficient objection.

If it is desired to put the business on a sounder basis the proper method is to credit reserves and not, *e.g.*, to charge expenditure which is obviously *capital* to revenue; or, to write off debts as "bad" which are merely overdue; or, to provide inflated reserves for doubtful debts.

VI

THE BALANCE SHEET

Nature of a Balance Sheet—Debit Side—Creditors—Bills Payable—Reserves—Loans—Credit Side—Verification of Assets—Land and Buildings — Mortgages — Investments — Insurance Policies — Patent Rights — Goodwill—Plant and Machinery—Loose Tools—Stock in Trade—Book Debts—Bills Receivable.

WHEN all the profit and loss items have been eliminated from the Trial Balance we have left those items which appear in the Balance Sheet. It is incorrect to state that the Balance Sheet is a summary of assets and liabilities. It is merely a summary of the balances in the books after the Revenue Account is completed.

No rules can be laid down as to the precise form in which the Balance Sheet should be presented, although it has long been an academic question among professional accountants. We prefer to give the customary method, but it is not suggested that it is any more or less correct than any other clearly drawn Balance Sheet; its sole virtue being that it is the one most familiar—and therefore most acceptable to business men—the general lines of which are as follows:—

(i.) The capital and liabilities are set out on the left-hand or debit side and the assets opposite

(ii.) The assets are grouped together in their order of realisability, and the liabilities set opposite in the same order. It is immaterial whether the most realisable asset is placed first or last, providing the general order is maintained.

(iii.) Fictitious assets, such as Preliminary Expenses of a limited company, are set out at the foot of the assets.

Dealing first with the debit side we find included here all the liabilities of the business and also the capital. The special items appearing only in certain classes of undertaking are discussed elsewhere—the general headings only are discussed here.

Bank Overdraft.—This item will be verified in the same manner as a bank balance (see *ante*, p. 31).

Trade Creditors.—These will be taken from the Bought Ledger. A well-drawn balance sheet will include under this heading only those liabilities which have arisen solely out of trade. From this figure can be deducted the reserve made, if any, for discount which it is expected will be received on payment of accounts.

The auditor should compare the ledger balances with "stock-taking statements" sent in by creditors, carefully inquiring into any discrepancies, and insisting that any errors thus revealed be corrected before he agrees to certify the Balance Sheet without comment.

This is particularly important, as "stock-taking statements" will prove a ready means of revealing any invoices suppressed with the object of inflating the profits.

In the *Irish Woollen Company, Ltd.* v. *Tyson and Others*, the auditor was held to be negligent where he

neglected the precaution of inspecting stock-taking statements.

Bills Payable.—This item represents the balance of the bills payable account. The auditor should extract from the Bills Payable Book a list of the actual bills, making up the balance and reconcile the total with the total as shown in the Balance Sheet.

If, for the purpose of finance, any accommodation bills are accepted or endorsed, inquiry should be made as to the extent and nature of the transactions and the contingent liability noted in the accounts.

Reserves for Amounts estimated owing.—The auditor should exercise care in seeing that all the items are included under this heading. He will be well advised to compare present reserves with those of previous years; and to satisfy himself that any which are eliminated are no longer chargeable.

In addition notes should be taken during the course of the audit of any matters giving rise to such liabilities.

Loans to the Business.—The auditor should inquire into the circumstances of the loan, and take the precaution of seeing that any interest which is due is charged in the accounts.

Turning now to the Asset side of the Balance Sheet, it is the auditor's duty to verify the existence of the assets as shown by the Balance Sheet. This principle was laid down in the *London Oil Storage Company, Limited* v. *Seear, Hasluck and Company*, in which auditors were held liable in damages where they neglected to verify the existence of the Cash Balance, and this case, it is thought, covers the principle that it is the auditor's duty to verify the existence, but not necessarily

the value, of the assets. Before particularising it will be as well to consider the general attitude of the auditor in respect thereto.

Evidence should be obtained wherever possible for the verification of assets, and this evidence should—for preference—be from a source outside the business. This is, of course, impossible at times, and in this case the auditor should be careful to trace all the transactions giving rise to the asset through the books. Furthermore, the auditor must be practical in this matter. His requirements should be such that the compliance with them will not cause undue inconvenience to his clients, or tend to injure his client's business or reputation, *e.g.* the auditor will not be justified in requiring an acknowledgment of indebtedness from the whole of the debtors of an ordinary merchant.

Another matter to be borne in mind is the object of the particular audit on which the auditor is engaged. For instance, if the audit is that of a partnership in which all the partners carry on the business, he can expect the partners themselves to preserve the value of the major portion of the assets without a close investigation by him. On the other hand, the audit of trust accounts should always include the verification of all the assets. The auditor cannot as auditor make any amendments of the valuations. He can, of course, make recommendations to the directors or managers of the business, and may give a qualified certificate, but he should be careful for his own protection to qualify his certificate where he considers the valuation excessive. As a general rule, the basis of valuation should be the cost price of the asset, less a reserve for depreciation or

amortisation. Where no mention is made in the following notes as to valuation this rule must be assumed.

The following suggestions are offered as to the verification of the various forms of assets.

Land and Buildings.—The title deeds of freehold property should be inspected where they are in possession of the owner of the property or his agent. If the property has been mortgaged an acknowledgment should be obtained from the mortgagee that he holds the title deeds. In the case of leaseholds, the auditor should inspect the lease and see that proper provision is made against redemption.

In any case where the property is mortgaged, the fact should be stated in the Balance Sheet.

Mortgages on Land and Buildings.—In verifying this asset it is necessary to see—

(i.) The mortgage deed.

(ii.) The title deeds to the property.

(iii.) The last receipt for premium on fire insurance policy on the mortgaged property.

(iv.) In the event of the mortgage being a second charge on the property, an acknowledgment should be obtained from the first mortgagee to the effect that he holds the title deeds and the receipt for the last fire insurance premium.

Investments.—A note is necessary as to the valuation of investments. Probably the most convenient method of providing against the continual fluctuations in value is to take the asset at actual cost and to provide a reserve for any losses which may arise. It will, of course, be the duty of the auditor to see that such a reserve is adequate.

As to the verification of the existence of the asset it is necessary to see the certificate for the stock or shares and broker's notes for all new investments. In the case of inscribed stock—such as Consols—a certificate should be obtained from the bank keeping the books, stating that the stock was duly inscribed at the date of the Balance Sheet.

In obtaining the certificate it is necessary to have the request signed by one at least of the holders of the stock, and a fee is usually payable. The auditor should have the certificate sent direct to himself.

Insurance Policies.—For the verification of the existence of the policy it is necessary to see the policy itself, also the receipt for last premium paid.

It is advisable that the premiums be debited to Profit and Loss Account, but it is permissible to capitalise a portion of the premiums provided the policy does not appear in the Balance Sheet at a figure greater than the surrender value, unless there is information available of sufficient certainty to ascertain the exact value of the policy to the business as shown in the example following.

Where the sum is payable under the policy on the death of a certain person the value of the policy as an investment is dependent on the life of that person, and consequently should be valued with some caution, since the mortality tables cannot be relied upon to correctly forecast the death of one or two isolated persons who are insured under the policies under review. The student will note that this will not apply to the valuation of a Life Insurance Company's liability on policies issued by them, since in that case the number of risks are sufficiently numerous to render the information revealed by

the mortality tables a sufficiently stable basis on which to make a valuation. If, however, the policy under consideration matures at a certain known future date, *e.g.* an endowment policy, we have certain information on which we can make up the accounts with much greater accuracy. The following method is recommended.

Such sum set aside annually as will with interest at a fixed rate per cent. (3 per cent. is a reasonable rate) amount to the sum payable under the policy should be capitalised. The difference between this sum and the amount of the policy will be debited to Profit and Loss Account. Interest on accumulating premiums will be debited to the capitalised portion of the premiums and credited to Interest Account, so that the capitalised premiums and interest will amount to the sum insured by the time it is due.

Example.—Assume that an endowment policy for £1000 is payable in ten years, that the annual premium is £90, payable January 1st in each year. It will be found that an annuity for £87 5*s.* 0*d.* will amount to £1000 in ten years approximately, then the Policy Account would appear as shown on pp. 70 and 71.

Where the policy is purchased during its currency, the purchase price should be capitalised, and the amount, together with the interest which will accumulate on it in the period, be deducted from the sum insured in calculating the annuity required.

Patent Rights.—The valuation of this asset is a matter which requires considerable care. There are two distinct cases—each requiring distinct treatment—which come under the auditor's notice.

In the first place, we have the case where the auditor's

client is the original patentee. The cost of obtaining the patent may be capitalised but not renewal fees. This figure may be verified by production of the bills of the patent agents.

The capitalisation of the cost of experiments and of placing the article on the market should not be encouraged, and in any case received with the utmost conservatism.

In the second case—that of the purchase of a patent—the auditor's duty will be to inspect the purchase agreement to see that the rights have been transferred and that the asset has been brought into the books at cost. In all cases it must be remembered that an English Patent usually only lasts fourteen years, and should be written off well within the period.

The argument which is frequently advanced to the effect that a patent does not become valuable for some time after it is granted and therefore should not be written off, is not sound reasoning, and should not be followed in practice.

Goodwill.—While the meaning of the term *goodwill* is usually properly appreciated, attempts to define it have been, on the whole, extremely weak.

We are told that it is the "probability of old customers going to the new firm," and as "the benefit arising from connection and reputation."

Goodwill should never appear in a Balance Sheet unless payment has actually been made for it either in money or in kind.

Though it has been argued that it is theoretically incorrect to write off goodwill, there is not the slightest doubt that it should be written down in practice, since it

INSURANCE

Dr.

Year.			Capital. £	s.	d.	Revenue. £	s.	d.
I.	January 1	To Cash.	87	5	0	2	15	0
	December 31	,, Interest on £87 5*s.* 0*d.* @ 3 %	2	12	4			
			89	17	4			
II.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £177 2*s.* 4*d.* @ 3 %.	5	6	3			
			182	8	7			
III.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £269 13*s.* 7*d.* @ 3 %	8	1	9			
			277	15	4			
IV.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £365 0*s.* 4*d.* @ 3 %.	10	19	0			
			375	19	4			
V.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £463 9*s.* 4*d.* @ 3 %.	13	18	1			
			477	2	5			
VI.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £564 12*s.* 5*d.* @ 3 %	16	18	9			
			581	6	2			
VII.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £668 11*s.* 2*d.* @ 3 %	20	1	0			
			688	12	2			
VIII.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £775 17*s.* 2*d.* @ 3 %	23	5	6			
			799	2	8			
IX.	January 1	,, Cash.	87	5	0	2	15	0
	December 31	,, Interest on £886 12*s.* 8*d.* @ 3 %	26	7	4			
			912	15	0			
X.	January 1	,, Cash.	87	5	0	2	15	0
		£	1000	0	0			

POLICY ACCOUNT.

Cr.

Year.			Capital.			Revenue.		
			£	s.	d.	£	s.	d.
I.	December 31	By Profit and Loss Account .				2	15	0
II.	,, ,,	,, ditto .				2	15	0
III.	,, ,,	,, ditto .				2	15	0
IV.	,, ,,	,, ditto .				2	15	0
V.	,, ,,	,, ditto .				2	15	0
VI.	,, ,,	,, ditto .				2	15	0
VII.	,, ,,	,, ditto .				2	15	0
VIII.	,, ,,	,, ditto .				2	15	0
IX.	,, ,,	,, ditto .				2	15	0
X.	,, ,,	,, ditto .				2	15	0
		,, Cash	1000	0	0			
		£	1000	0	0			

is a completely intangible asset which for sake of the financial soundness of the business should be written off or a specific reserve for its reduction built up.

Plant and Machinery.—The verification of this asset includes the inspection of the invoices relating thereto, and the purchase agreement where working plant has been taken over from the vendor of a business. The question of depreciation is discussed in another place.

In deciding whether a purchase or expense should be added to this asset or charged to Revenue, much depends on the circumstances of the case. The broad rule to be followed is that anything in the nature of improvements or additions may be properly capitalised.

Plant, Machinery, Rolling Stock, etc., on the Hire Purchase System.—The auditor should see a copy of the hire purchase agreement and trace the payments through the accounts. The total instalments should not be treated as the purchase price, since a certain amount of interest is added to compensate for the payment by instalments. The correct valuation will be the cost, less depreciation, less the present value of unpaid instalments, therefore if we debit, say, our machinery account with the cost of 100 sewing machines we purchase on the hire purchase system and credit the sewing machine company with the same amount, we will have the correct figure at the opening of the agreement. Subsequently we will debit the instalments paid to the machine company, crediting it with interest on the diminishing balance at a rate which will allow the total instalments to pay off both principal and interest. We must, of course, write depreciation off the cash value of the machines from time to time.

Authorities differ as to the proper method of stating the asset in the final accounts, but most are agreed that the machines should be stated in the Balance Sheet as being on the hire purchase system until fully paid for. Probably the following will be found suitable in most cases :—

	£ s. d.	£ s. d.
Machines on Hire Purchase System, cash value . . .	1500 0 0	
Less Depreciation 10 per cent	150 0 0	
	1350 0 0	
Less present value of unpaid instalments .	1200 0 0	
		150 0 0

Loose Tools.—Stock should be taken of loose tools and the sheets properly certified. The loss should be written off each year; where, however, it is decided to provide for the expense by charging depreciation, a periodical inventory should be made to see that the provision is adequate.

Stock-in-Trade.—By far the most important matter which calls for the auditor's consideration is that of *Stock-in-Trade.* The opportunities for fraud and chances of error which arise in regard to this matter will make it apparent—even to the casual observer—that the verification of this asset is the most important feature in the audit of a trading concern. While the decisions of the Court have, and justly, made the responsibilities of the auditor light—from a financial point of view—it is our duty, nevertheless, to do all in our power to verify the stock.

The general principle to be followed in the valuation is that the prices and values shall be at cost less any known losses; or at market value, whichever is the lower.

The following general rules are suggested:—

(1) The stock sheets should be certified as to quantity, quality, prices, extensions and additions by the officials responsible for each portion of the work, and generally by the Managing Director or some responsible official.

(2) The additions and some—if not all—the calculations should be checked.

(3) Prices should be checked in the following manner:

(*a*) Prices of raw materials should be checked with invoices, and these should agree.

(*b*) Manufactured articles should be valued at cost price, *i.e.* the actual cost of material, labour, and direct expenses.

(*c*) Goods which have a market quotation should be stated at market value as shown by the trade papers, provided that no such goods should be included above cost price.

(4) Quantities can only be checked in most concerns in a general manner. If, however, Stock Accounts are kept on a scientific basis, the stock sheets should be compared with the Stock Accounts and serious discrepancies inquired into.

In addition a general check can be obtained on the total stock by preparing an estimated Trading Account for the period under review. In making up this account all the amounts are known with the exception of the gross profit.

We can from our books obtain the initial stock, purchases, wages, and sales. The percentage of gross profit on turnover should then be ascertained from the accounts of previous years, and from this percentage it will be possible to ascertain the amount of gross profit proportionate to the turnover for the period under review. Adding this figure to our estimated Trading Account, it will be seen that the balance then standing on the account will approximate to the actual stock in hand in a business of a reasonably steady nature.

EXAMPLE

Let us assume that our opening *stock* is £2000, our purchases £10,000 for the period, and our sales £12,000, and our percentage of gross profit to turnover for previous years approximately 20 per cent., then the estimated Trading Account would be as follows:—

ESTIMATED TRADING ACCOUNT.

Dr.	£ s. d.		Cr. £ s. d.
To opening stock . .	2,000 0 0	By sales	12,000 0 0
,, purchases . . .	10,000 0 0	,, estimated closing stock . . .	2,400 0 0
,, estimated profit (20 % on sales) .	2,400 0 0		
	£14,400 0 0		£14,400 0 0

The *actual* stock should then approximately be £2400.

In the case of manufacturers it is of course necessary to provide for such items as wages, fuel, driving power, and other items in the Trading Account to arrive at a correct figure.

The Legal Position of Auditors with regard to Stock-in-Trade

The law is particularly lenient towards auditors, and reduces their responsibilities to a minimum in this direction.

In the first place, it is no part of his duty to take stock, and in the absence of suspicious circumstances he is entitled to rely on the word of trusted officers of the company. He is not responsible in damages if he fails to discover deep-laid schemes of fraud or sharp practice. He is stated in the leading case (Re *The Kingston Cotton Mills Co., Ltd.*) to be a "*watchdog and not a bloodhound*," and however uncomplimentary towards the profession it may be, the metaphor gives us the *key* to the position, so far as the law is concerned.

In the case above mentioned an action was brought against the auditors by the liquidator of the Kingston Cotton Mills Co., Ltd., for damages for dividends wrongly paid to the shareholders through the alleged negligence of the auditors.

The stock had been for some years regularly inflated by the secretary, with the object of paying dividends and bolstering up the credit of the company. The secretary had each year certified the stock sheets as correct, and the auditors had taken this certificate as final. It was proved that the secretary was an officer trusted by the directors and the company generally, and it was decided in the Court of Appeal—reversing the decision of the Divisional Courts—that the auditors were not responsible.

In a more recent case (*Mead* v. *Ball, Baker & Co.*) the rule was extended to include audits for purposes of

investigation for intending purchasers, and on an attempt to make the auditors liable—on an instance in which the negligence was proved—it was held in the Court of Appeal that it must be proved that damage was suffered which would not otherwise have been incurred but for the auditor's negligence.

To summarise the position, we may say that an auditor is not liable if he relies on the certificate of a trusted officer of the company, nor is he liable if he does not detect intricate frauds.

If, however, his negligence is proved, he is only liable for damages actually suffered through his negligence.

Goods in Bond or in Transit.— Where goods are *en route* from abroad or in bond or at the docks at the date of stock-taking the auditor should see the bill of lading, warehouseman's certificate, dock warrant, or any other document of title to the goods.

Stock Abroad on Consignment.—The auditor should require production of an acknowledgment from the agent abroad of the existence of the stock. Great care should be exercised in valuation, since it is frequently necessary to reconsign to other markets or even have them returned, when they cannot be sold at a reasonable figure.

The stock should be valued at cost plus charges incurred sending it abroad, *i.e.* freight, carriage, insurance, foreign duties, etc., and a substantial reserve raised to cover any loss.

Book Debts.—The list of debtors should be checked with the Sales Ledger. In going through the ledger, the auditor should note all accounts which appear to him to be overdue, doubtful or bad. Only general rules can be

laid down in this matter, as much depends on the facts of the case and the nature of the business.

The following are suggested as general rules :—

(i.) All accounts in respect of which bankruptcy or liquidation proceedings have commenced should be carefully scrutinised and a reserve made for estimated loss. As to the extent of this loss, the statement of affairs will give information sufficient for a rough estimate.

(ii.) All statute barred debts should be written off unless very strong evidence is given in support of their retention.

(iii.) The auditor should ascertain as far as possible the usual terms of credit and should inquire into any accounts which appear to him to be overdue.

Bills of Exchange Receivable.—The actual bills should be inspected and the total agreed with the Bills Receivable Account.

Where bills have been paid or discounted between the date of closing the books and the date of inspection, it is obvious that these bills cannot be produced; but the auditor should trace the payments through the Cash Book and Bank Pass Book. It is also advisable that bills paid into the bank immediately before closing the books should similarly be traced through the Pass Book.

In inspecting the bills in hand, the auditor should have regard to the following points :—

(i.) The general standing of those persons liable on the bills should be noted in order to ascertain whether there is a probability of any being dishonoured.

(ii.) Overdue bills should not be treated as *bills receivable.* Such bills should be treated as dishonoured and redebited to the person from whom they are received.

(iii.) The bills should be properly accepted, stamped and endorsed.

Incidental to the audit of bills receivable will be the ascertainment of the contingent liability on bills discounted, together with the consideration of the problem of reserving for expected loss through dishonour at maturity.

The auditor should extract from the Bills Receivable Book a list of bills discounted which have not yet matured. The total of this list should be noted on the Balance Sheet as a contingent liability on bills discounted—a reserve being made when it is thought this contingent liability will become fixed.

Cash and bank balances are verified by audit of the Cash Book. This is fully set out in the chapter on the Cash Book.

VII

DEPRECIATION, RESERVES, RESERVE FUNDS, ETC.

Depreciation—Various Methods—Legal View of Depreciation—Double Account System—Reserves and Reserve Funds—Insurance Funds—Sinking Funds—Secret Reserves.

AMONGST the most debatable of accountancy subjects we find those of depreciation and reserves.

The necessity for providing depreciation in some form or other needs no explanation or defence; but the various factors which influence depreciation may be usefully brought before the reader, they are:—

(i.) Lapse of time.

(ii.) Wear and tear.

(iii.) Obsolescence of

(*a*) The machinery itself;

(*b*) The article manufactured.

The effect of these varying factors on the asset will be the principal ground on which to determine the method of depreciation. Leases and the like are affected only by the first, whereas heavy machinery will be subject to all.

The following methods for providing for depreciation are in use:—

(i.) *A percentage* of the original value of the asset written off each year.

(ii.) *A percentage* of the diminishing balance of the asset account. On account of the percentage being calculated on a diminishing balance, the rate must be greater than in the first case.

(iii.) *Annuity Method.*—Here a fixed sum is written off each year and interest credited on the diminishing value of the asset. The fixed sum written off must be provided for both the capital value of the asset and accumulated interest.

(iv.) *Sinking Fund Method.*—As its name implies, this method is the renewal of the asset at the end of its life by means of a sinking fund, *i.e.* a sum set aside annually and invested, sufficient to provide with accumulated interest an amount equal to the value at the end of its life. If an endowment insurance policy is taken out for the amount of the asset payable at the estimated date that it is worked out, the effect is the same as raising a Sinking Fund, and the premiums on the policy may be treated as instalments to the fund.

(v.) *Re-valuation of the Asset from Year to Year*, the difference between the book value and the valuation figure being written off as depreciation.

(vi.) *A Sum set aside Annually sufficient to provide for Depreciation, Repairs, and Renewals.*—By this method the Profit and Loss Account is debited, and a Reserve Account credited, with

a fixed sum each year, and all repairs and renewals are charged against this reserve. It should be noted that in this case the reserve will accumulate from year to year until when the time comes for replacing the asset, it will be sufficient to bear the whole cost of replacement.

(vii.) *Double Account System.*—By this method we charge all renewals to Revenue, leaving the capital figure untouched, except for actual additions, as distinguished from replacements.

If this method is employed the foundation of the system must be noted and strictly followed, that is, that the works are kept up to a full state of efficiency, and in all cases it is advisable to raise a reserve for equalisation of renewals or a Depreciation Fund, in order that the later years will not be crippled with unduly heavy renewals.

The nature of the asset will, to a great extent, determine the question of the methods. Where the asset is one which depreciates principally or solely by reason of lapse of time, the better methods will be those which charge revenue with equal annual sums for the use of the asset.

This class of asset will include leases, patent rights and copyrights, the first of which is the best example. Dealing with this, therefore, from the simplest point of view, the first method enumerated will commend itself to the reader, as here we charge an equal sum to revenue to cover amortisation of the lease instead of rent. The sum paid for the lease may, however, be considered as a

capital sum paid in lieu of rent, so that the lease will gain a certain sum in consideration for loss of interest due to immediate payment.

We can give true effect to this in the accounts by means of the annuity method, *i.e.* by treating the sum paid for the lease as being the present value of an annuity equal to the rent. By this method the net charge to revenue—that is, the gross amount debited less the interest credited—will increase from year to year. This method is more correct since the earlier years will bear the greater loss by the heavier capital being locked up in the lease.

A careful examination of the Sinking Fund method will reveal the fact that it leads to precisely the same result.

The annual charge in respect of depreciation remains fixed, and the interest is adjusted automatically by reason of the interest on Sinking Fund instalments being credited to the Sinking Fund instead of to revenue. Arithmetically the net annual charges to revenue are identical in both cases, the net annual charge by the annuity method being equal to the Sinking Fund instalment plus the interest on the accumulated fund.

The nature of plant and machinery, buildings, tools, and similar assets, will not, however, admit of such close calculation.

The accuracy of the rate of depreciation is more dependent on the accuracy of the expectation of life and the residual value than on the elaboration of the depreciation calculations. Moreover, in practice additions are continually being made which will disturb the data on which the original estimates were made.

The annuity and Sinking Fund methods are not recommended in this case. In the first place, the information is not sufficiently determined to warrant such close calculations as these methods necessitate. Further, it has been already explained that the effect of these methods is to charge each succeeding year with an increasing amount—a result which is precisely contrary to that which is desired, as will be explained later.

The methods recommended are either—

(i.) A percentage on original value, which is preferable where the life of the asset is short.

(ii.) A percentage on the diminishing value.

(iii.) The re-valuation method, which is particularly suitable for loose tools; or

(iv.) An equal annual charge to cover both repairs and depreciation.

The diminishing value method has many advantages, as it provides in some small measure for the special considerations affecting this class of asset. The greater efficiency of new machinery is reflected in the accounts in the heavier charges for depreciation in the earlier years, whereas the increased expense of repairs in the later years is compensated by reduced charges for depreciation.

The fact that the asset can never be entirely written off by this method is also a point in its favour, since machinery can never be entirely valueless whilst scrap iron is a marketable commodity.

The rate of depreciation should be such as will provide for the asset being written down to its residual value within the expected life.

It should be noted that as the percentage is based on

estimates only, there can be no advantage in calculating it at the exact rate as justified by the figures, but rather at the nearest workable figure ; *e.g.* if we are writing plant and machinery down to 10 per cent. of the original value in ten years, the rate of depreciation will be about 20·57 per cent., but 20 or 22½ per cent. will be sufficiently accurate for all practical purposes ; the former producing ing about 10½ per cent., and the latter about 8 per cent.

Although the necessity for depreciation is beyond question from a business standpoint, the legal position is by no means so obvious, indeed all the decided cases tend to show that there is no legal necessity for providing for depreciation.

In *Lee* v. *Neuchatel Asphalte Company, Limited*, the Court of Appeal held that a company may provide by its articles for the distribution of dividends before providing for depreciation of fixed assets. Though in this case the depreciation in the assets was not provided, it was proved that the assets more than covered the share capital.

But in *Verner* v. *The General Commercial Investment Trust, Limited*, the same Court refused to restrain the company from paying a dividend out of current profits without providing for capital lost, providing it was solvent at the time. A similar decision was given in *Bolton* v. *Natal Land and Colonisation Company*, even though the company had previously written up the land and credited Profit and Loss Account with anticipated profits. Mr. Justice Romer stated that " the fact of the company having written up the value of the land . . . did not place them under any obligation to bring into account

in every subsequent year the increase or decrease in the value of their lands."

The question of depreciation was further considered in *Wilmer* v. *M'Namara and Company, Limited*, with a similar result—the company being allowed to pay dividend without providing depreciation of fixed assets, though in this case the articles were silent on the point. It appears, however, to be doubtful whether these decisions would be upheld in the House of Lords (*Dovey* v. *Cory, re National Bank of Wales, Limited*).

Depreciation and the Double Account System

Statutory forms ignore depreciation but usually provide for the charging of renewals to Revenue.

The Double Account system is based on this principle, it being assumed that the undertaking is kept up to full efficiency. If this is the case there can be little objection to the system, but it is to be noted that this ideal is difficult to maintain. The majority of the assets comprised in the capital account are naturally wasting, so that at any period these appear at their full cost, assets all of which are in a more or less depreciated condition.

Further, if assets are not renewed the original outlay, though sunk and lost with nothing whatever in its place, appears at cost, and to this extent it will be seen that the value of the undertaking is overstated. A depreciation fund will therefore be necessary to equalise charges to revenue in respect of renewals. Such a fund has the additional benefit of counteracting the evil effects of the watered capital which is carried by these concerns.

The treatment of the replacement of an asset by one

of greater efficiency is a problem which has received some considerable notice, and there seems to be some diversity of opinion on it.

Two methods are strongly supported.

(i.) To charge to revenue the cost of the old asset and the difference to capital as being the cost of greater efficiency.

(ii.) To charge to revenue the sum which would be required to replace the old asset at the present time and to charge the difference to capital as the cost of added efficiency.

Example

Offices costing £10,000 are replaced by a building with twice the accommodation for £18,000. Estimated cost of building old offices £12,000.

By the first method, £10,000 is charged to revenue and £8,000 to capital; but by the second method £12,000 is charged to revenue, and £6,000 to capital.

Examination of this example reveals the fact that there is an appreciation of £2,000, which we must utilise either by crediting to revenue or by keeping down the amount of the capital expenditure.

By the first method, revenue benefits by being debited with £10,000 instead of £12,000; whereas in the second, capital is reduced by £2,000, inasmuch as an asset costing £18,000 appears at £16,000 only.

The advantages of the first method are.

(i.) The cash basis of the Double Account system is maintained throughout.

(ii.) The general effect of replacing old figures by new ones, instead of merely adjusting the

older figures by a theoretical rule, has a tendency towards increasing the reliability of the accounts.

(iii.) The accounts are based on actual figures as against estimates in the second method.

The advocates of the second method rely principally on the fact that the cost of materials and labour have a tendency to increase, so that, whilst there may be difficult problems to face should the estimated cost of replacement come out less than the original cost, we have *consistently* the advantage of keeping down the capital expenditure. We must bear in mind also that this method adheres more rigidly to the rule that only additions are to be capitalised than does the former method.

Reserves and Reserve Funds.—The loose application of the terms: Reserve and Reserve Fund has led to much confusion as to their precise meaning. Much unprofitable discussion has been spent on these terms, arising out of attempts to fix a name on the various provisions which are made in accounts.

It must be noted that this question is purely one of terminology, for whether we call an *account* a *Reserve* or a *Reserve Fund* does not alter its nature in the least, nor does it convey any difference of meaning to the commercial mind; but probably the views of the principal writers on the subject will be interesting.

Mr. F. W. Pixley, F.C.A., in his work on auditors states that: "A 'Reserve' is merely the surplus of the credit side of the Balance Sheet over its debit side, although perhaps the 'Reserve' may be divided under two or three more headings, such as 'Reserve' and 'Balance of Profit and Loss Account carried forward.'

"A 'Reserve' of this nature is either a provision against loss of capital or a reserve for the equalisation of dividends, or a reserve as an extra inducement to those with whom the company may do business to give credit.

"A 'Reserve Fund,' however, is not merely a surplus shown on the debit side of the Balance Sheet, but must be represented by special investments, which may or may not be shown distinctly on the credit side of the Balance Sheet. If, therefore, the reserve is used in the general business of the company, it is not a 'Reserve Fund,' although, perhaps, the term might be properly so used if some stock, used in the ordinary course of the business, was specially set aside and when made use of represented by cash set aside until reinvested in further stocks and specially earmarked."

On the other hand, Mr. L. R Dicksee, M.Com.F.C.A., in "Auditing," contends that—

"There can be no doubt that it is improper to state as a Reserve Fund any sum which has not been actually set aside, out of profits, solely for the purpose of providing against unforeseen contingencies," but that "the view generally held by those competent to judge is that it is not—under ordinary circumstances—desirable that a Reserve Fund be specially invested if the moneys can be utilised to better advantage in the business itself, or in reducing its liabilities."

The greatest point of variance, it will be seen, is the question whether a Reserve Fund be invested outside the business.

Where the fund is for a specific purpose, *e.g.* redemption of debentures or an insurance fund, there is no doubt that this should be covered by investments

outside the business ; but the question whether a simple provision out of profits to provide for unknown contingencies (*i.e.* that which is commercially described as a Reserve Fund) appears to be primarily a practical point to be decided on the merits of each particular case, the name being of but secondary importance.

Insurance Funds.—The practice of raising a reserve to cover risks which were previously covered by insurance policies, and thus saving the premiums, has become popular in recent years. Whilst this system has the advantage of being economical, great care must be taken to see that the reserve is started and maintained on a thoroughly sound basis. The nature of the risks to be covered is the most important factor ; indeed, the number and variety of the risks must be sufficiently large to allow the law of averages to operate ; *e.g.* it would be unwise for a single ship company to start an insurance fund to cover the risks attending that ship, for the risk to be covered by the fund is the loss of the whole undertaking, so that to be adequate, the fund should equal the value of the whole undertaking. This will apply to a company with but one or two works, factories or warehouses.

On the other hand, a company running a fleet of steamers may advantageously open a fund to provide against the risks attending the whole fleet, since in this case the number of risks will justify a reserve very much smaller than the aggregate risk ; indeed a sum little larger than the greatest risk of total loss would be sufficient, provided it is fortified annually by a sum in lieu of premiums paid.

It will be seen, therefore, that certain risks are

peculiarly adapted for insurance funds: in particular the following may be mentioned:—

(i.) Fire or burglary in multiple shop companies.

(ii.) Workmen's compensation risks of a large number of employees.

(iii.) Marine insurance risks where the number and variety of shipments is sufficiently large to allow the law of average to operate freely.

Investments outside the business should always be made to cover the amount of the insurance fund, so that it may always be available in cases of loss; such investments should be easily realisable and of a thoroughly sound if not "gilt-edged" class.

Sinking Funds.—A sinking fund is a sum set aside out of profits and invested outside the business for a certain specific purpose. The object of such a fund is to set aside periodically such a sum as will amount at compound interest to a certain sum required at a given date. In practice they are found to fall under two headings:—

(i.) A fund raised to provide for the renewal of an asset.

(ii.) A fund raised to repay a loan.

The first is an accumulating depreciation fund, whilst the latter is an accumulating reserve, so that the object of the fund should be stated in the Balance Sheet if a true view is to be given.

Where both classes are found in one business or the same undertaking, they should be separately stated, or at least the total of each class.

It is found in practice that the annual contributions to a sinking fund raised to repay a loan are frequently

treated in the reserve account as being in lieu of depreciation, consequently no provision is made for the wasting of fixed assets. This practice has been strongly criticised and the varying opinions are stated elsewhere; the point here to note is that though raised for the purpose of repaying a loan, the fund is not an accumulating reserve, but a depreciation fund, and should be so treated in the accounts.

Secret Reserves.—A secret reserve is one created by under-stating the value of the assets or overstating the liabilities, such discrepancy from the true state of affairs being made with *the object of creating a reserve and not disclosing the fact in the accounts.*

The object in most cases is the equalisation of dividends and to prevent undue fluctuations in the profits as disclosed by the accounts. Whilst this is the sole object there can be little objection to the practice, but the subject has so many complications that a strong weight of opinion is against the practice. To decide the matter is most difficult, and the special circumstances of each case would be sufficient to upset the arguments *pro* and *con*.

There can be little doubt that in very many cases a secret reserve is most desirable, yet on broad grounds we are impelled towards disapproval of accounts which are not only incorrect but deliberately falsified.

Secret reserves add stability to a business, and where properly used can be most beneficial from a practical point of view. Apart from this there appears to be nothing to justify their existence. There is, however, a mass of evidence piled up against internal or secret reserves.

The auditor's position is most difficult. He is required to report that a Balance Sheet is "true and correct," when it was never intended to be such. It is true that he is justified by the law in so doing (see *Newton* v. *B. S. A. Company, Ltd.*); but the same case imposed on him the duty of satisfying himself as to the director's *bona fides*, and of seeing that the reserve is applied in such a manner which is not *ultra vires* the company.

In these matters the auditor's discretion is taxed to the utmost. He is required to satisfy himself that acts which are *primâ facie* evidence that the directors are not dealing openly with the shareholders, are in reality beneficial to them.

No definite rules can be laid down for the guidance of the auditor in these matters, but it is suggested that the auditor do all in his power to ascertain whether the directors

(i.) Are using the secret reserve with a view to "rigging the market," and thus gaining an advantage over the general public in speculating in the company's shares.

(ii.) Whether the directors are using their private information for their own benefit; *e.g.* where the reserve has been recently created he should see whether the directors have bought shares shortly after the issue of the Balance Sheet.

In connection with the subject of secret reserves, we have the decision in *Newton* v. *Birmingham Small Arms Company, Limited.* In this case Mr. Justice Buckley considered the auditor's legal position, and the following,

it is thought, is a fair summary of the effect of the judgment :—

(i.) Any article of association restricting the auditor's freedom of investigation and right to report thereon is void, it being contrary to section 113 of the Companies (Consolidation) Act, 1908, and this extends to secret reserves.

(ii.) The balance sheet does not necessarily fail to be true and correct merely because the assets are understated.

(iii.) The auditor has the right to investigate the accounts relating to the secret reserve, and also has the right to report thereon.

(iv.) The fund must not be used for a purpose which *ultra vires* the company.

(v.) The shareholders' right to a true balance sheet may be negatived by the company's own articles of association.

VIII

THE COMPANIES (CONSOLIDATION) ACT, 1908

Appointment of Auditors—Remuneration—Rights and Duties—Certificates —Statutory Report—Annual Summary—Audit of Companies' Accounts —Share Capital—Debentures—Preliminary Expenses—Underwriting —Forfeited Shares—Profits prior to Incorporation—Directors' Remuneration.

The Companies (*Consolidation*) *Act*, 1908, contains certain provisions with relation to the accounts and audit of companies formed under that Act. Originally the Companies Act, 1862, contained no provision for the appointment of auditors except those contained in the original TABLE A, which, of course, could be excluded by the companies' own articles of association.

The Companies Act, 1879, however, introduced the principle of compulsory audit to company law, and provided (section 7) that the accounts of banking companies registered after the passing of the Act should be examined by auditors who should make a report on the accounts examined by them and of every balance sheet laid before the company in general meeting. Such report had to state whether the balance sheet was "a full and fair balance sheet, properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs, as shown by the books of the company.

Later (by the Companies Act, 1900), the liability to compulsory audit was extended to cover all companies registered under the Acts. The auditors were required to sign a certificate at the foot of the Balance Sheet stating whether or not all their requirements as auditors had been complied with, and make a report to the shareholders on the accounts examined by them, and on every Balance Sheet laid before the company in general meeting during their tenure of office; and in every such Report state whether, in their opinion, the Balance Sheet referred to in the Report was properly drawn up so as to exhibit a true and correct view of the company's affairs as shown by the books of the company.

The last provision prior to the consolidation was contained in the Companies Act, 1907, which extended the earlier provisions.

The law as it is at present is contained in the Companies (Consolidation) Act, 1908, as amended by the Companies Act, 1913, and all references in the remainder of this chapter are to the principal Act.

Appointment.—The auditors of the company may be appointed by the directors before the statutory meeting, and if so appointed hold office until the first annual general meeting, unless previously removed by a resolution of the shareholders in general meeting, in which case the shareholders at that meeting may appoint auditors.

Afterwards the auditors are appointed by the shareholders at each annual general meeting, and hold office until the next annual general meeting. The directors have power to fill casual vacancies but surviving auditors have power to continue to act.

If an appointment of auditors is not made at an annual general meeting, the Board of Trade may, on the application of any member of the company, appoint an auditor of the company for the current year, and fix the remuneration to be paid to him by the company for his services.

A director or officer of the company cannot be appointed auditor of the company, nor can any person, other than a retiring auditor, be appointed at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a shareholder to the company not less than fourteen days before the general meeting.

Where another person is so nominated the company must send a copy of the notice to the retiring auditor and to the shareholders not less than seven days before the annual general meeting.

If after notice of the intention to nominate an auditor has been so given, an annual general meeting is called for a date fourteen days or less after the notice has been given, the notice, though not given within the time required by this provision, shall be deemed to have been properly given for the purposes thereof, and the notice to be given by the company may, instead of being given within the time required by this provision, be given at the same time as the notice of the annual general meeting.

Remuneration.—The auditor's remuneration is fixed—

(i.) By the company in general meeting, if the company have appointed him.

(ii.) By the directors where they have made the appointment under section 112.

(iii.) By the Board of Trade where they make the appointment on the application of a shareholder.

Rights and Duties.—Section 113 of the Act is of such importance that it is reproduced here *in extenso*—so far as it relates to the duties of auditors and the publication of accounts in general.

113.—(1) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors.

(2) The auditors shall make a report to the shareholders on the accounts examined by them, and on every Balance Sheet laid before the company in general meetings during their tenure of office, and the report shall state:—

(*a*) Whether or not they have obtained all the information and explanations they have required; and

(*b*) Whether, in their opinion, the Balance Sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

(3) The Balance Sheet shall be signed on behalf of the board by two of the directors of the company or, if there is only one director, by that director, and the auditor's

report shall be attached to the Balance Sheet, or there shall be inserted at the foot of the Balance Sheet a reference to the report, and the report shall be read before the company in general meeting, and shall be open to inspection by any shareholder.

Any shareholder shall be entitled to be furnished with a copy of the Balance Sheet and auditor's report at a charge not exceeding sixpence for every hundred words.

(4) If any copy of a Balance Sheet which has not been signed as required by this section is issued, circulated, or published, or if any copy of a Balance Sheet is issued, circulated, or published without either having a copy of the auditors' report attached thereto or containing such reference to that report as is required by this section, the company, and every director, manager, secretary, or other officer of the company who is knowingly a party to the default, shall on conviction be liable to a fine not exceeding fifty pounds.

It must be distinctly understood that the auditor is appointed to audit for the shareholders, and that he must report to the shareholders and not to the directors.

If he is convinced that there are irregularities in the books he should not be content with remonstrating with the directors. His duty under the Act is clear: he must report to the shareholders if the accounts are not presented in a manner which he considers satisfactory (*Re London and General Bank, No* 2).

It will be seen that the auditor has the right to inspect books: this includes the statistical records and also the Minute Book. He has also the right to inquire

into and if necessary to report upon a Secret Reserve raised in the accounts (*Newton* v. *B.S.A. Co., Ltd.*). He may inquire into any matters which he considers necessary to the audit, and any attempts to limit that power either by the directors or by the shareholders themselves in general meeting is *ultra vires*, and any clause in the articles of association limiting the powers of the auditors in any way is void (*Newton* v. *B.S.A. Co., Ltd.*).

The auditors' report should clearly set out all matters with which the auditor is not satisfied.

Where there are irregularities a vague statement calculated to cause the shareholders to make inquiries is not sufficient, and the auditor will be guilty of misfeasance if he makes such a report when dissatisfied (*Re London and General Bank, Ltd., No.* 2).

The following is an example of an auditors' report in compliance with s. 113, sub-s. (2) :—

REPORT OF THE AUDITORS TO THE SHAREHOLDERS OF THE A B COMPANY, LIMITED.

We have audited the Balance Sheet of the A B Company, Limited, dated the 31st December, 1913, as above set forth.

We have obtained all the information and explanations we have required.

In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the company's affairs according to the best of our information and the explanations given us and as shown by the books of the company.

(Signed) C. D.
Auditor.

In the case of banking companies, the above provisions are modified in detail.

The auditor is not required to audit accounts of branches beyond the confines of Europe, it being sufficient if he is allowed access to the statements forwarded by the branch to the head office.

The Balance Sheet also requires the signature of the manager or secretary (if any), and if there are more than three directors, at least three, and if there are not more than three, then all the directors.

In connection with the statutory report under section 65, it is provided that :—

"The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the auditors, if any, of the company."

The certificate required to be signed by the auditors with regard to the statutory report is as follows :—

We hereby certify that so much of this Report, as relates to the shares allotted by the company and to the cash received in respect of such shares and to the receipts and payments of the company of capital account is correct.

} Auditors.

Dated this day of 19 .

The annual list and summary must contain a statement made up to such date as may be specified in the statement, in the form of a Balance Sheet, audited by the

company's auditors, and containing a summary of its share capital, its liabilities, and its assets, giving such particulars as will disclose the general nature of those liabilities and assets, and how the values of the fixed assets have been arrived at, but the Balance Sheet need not include a statement of profit and loss. This provision does not apply to a private company as defined by the Acts (see s. 121 and the Companies Act, 1913).

It has recently been decided that the company must, in this statement, state separately the values of the tangible and intangible fixed assets, and that the inclusion of: "Goodwill, trade marks, machinery, furniture and fixtures" as one item is not a sufficient compliance with the section (*Galloway* v. *Schill, Seebohm & Co., Ltd.*).

It has been decided that an auditor is an officer of the company for the purpose of s. 10 of the Companies (Winding-up) Act, 1890, now s. 215 of the Companies (Consolidation) Act, 1908, and is therefore liable to have proceedings taken against him under that section (*Re The London and General Bank, Ltd.; Re Kingston Cotton Mills, Ltd.*).

THE AUDIT OF THE ACCOUNTS OF A LIMITED COMPANY

The duties of the auditor under the Act have already been set out. It now remains to point out the various matters which affect auditors in particular.

One of the first duties is to peruse the company's

memorandum and articles of association, and the auditor should carefully note any matters which appear to him to be important: *e.g.* the remuneration of the directors; provisions (if any) as to depreciation. Throughout the audit he should have regard to these regulations and to the provisions of the Act, and see that neither the company nor the directors are committing any act which is *ultra vires.*

The accounts relating to share capital should be carefully audited.

A satisfactory audit programme for auditing the share capital would be as follows:—

1. Check the Applications and Allotments Book with
   (*a*) The letters of application.
   (*b*) Directors' minutes as to shares allotted and applications refused.
   (*c*) The Bank Pass Book as to cash received on application and allotment, and application monies returned.
   (*d*) The Share Ledger.
2. See that the minimum subscription has been obtained and the amount due on application thereon has been actually received.
3. Check the counterfoils of share certificates issued with the Share Ledger.
4. As to calls, similar procedure will be followed. In addition the auditor should inspect the minutes of the directors' meeting sanctioning the call and also see that the formalities required by, and provisions as to calls in, the company's articles of association have been duly carried out.

5. Where shares are issued for a consideration other than cash, the facts will be verified by reference to the agreement.

Premium on Shares.—The Act provides that shares may NOT be issued at a discount, but there is nothing to prevent a company issuing its shares at a premium.

Where a premium is so received, it is advisable to transfer it to a reserve account, or to use it in writing off the preliminary expenses of the company, and not to take credit for it in the Profit and Loss Account.

Apart from provision there may be in the company's own articles, there is no legal objection to distributing the amount in dividend, but such a proceeding cannot be recommended.

Transfers of Shares should be checked in the following manner:—

1. Check the Transfer Register.
   (*a*) With the transfers themselves.
   (*b*) The Share Ledger.
   (*c*) As regards fees receivable, with the financial books.
2. Inspect the Share Certificate Book to see that all new certificates issued are accounted for by transfers or letters of indemnity produced.
3. Scrutinise the transfer deeds to see that—
   (*a*) They are properly stamped;
   (*b*) Duly executed;
   (*c*) The shares transferred are duly evidenced by returned certificates cancelled by the company.

An issue or transfer of debentures would follow on very similar lines as an issue of shares.

The following particular points must be noted :—

(i.) The company's borrowing powers and also the previous borrowings should be carefully considered to see that it is not, by issuing these debentures, exceeding such powers. The terms and conditions on, and circumstances under which the debentures were issued are points which the auditor will be well advised to make careful inquiry, and he should consider, even if in law it may not be part of his duty, the effect on the company's finances and prospects.

(ii.) Where the debentures, as they usually do, give a charge on the assets of the company, the auditor should see that a general statement of the nature of the charge is included in the Balance Sheet.

(iii.) The *expenses* of the issue should be written off within the period for which the debentures are issued. Where the debentures have been issued at a discount and are redeemable at par or over, the discount should be carefully written off, as should the premium when they are redeemable at a premium.

(iv.) Where there are clauses in the trust deed, or in the debentures themselves, requiring the raising of a sinking fund or the guaranteeing of the issue by an insurance company, the auditor should see that these are duly carried out.

Preliminary Expenses should be written off within a short period after the incorporation of the company.

The common practice is to spread these expenses over a period of three to five years.

Preliminary expenses will include :—

(i.) Stamp duties and fees on the capital and registration of the company.

(ii.) Stamps and law costs (if any by the company) on the purchase agreement.

(iii.) Law costs, printing, cost of filing prospectus, memorandum, and articles of association.

(iv.) Accountants' and valuers' charges, in connection with formation of the company and the prospectus.

(v.) Cost of preparing and stamping letters of allotment.

(vi.) Company's seal. Share certificates and books.

Underwriting Commissions.—Where underwriting commissions have been paid, the auditor should inspect the agreement with the underwriter and also see that the amount and rate per cent. is sanctioned by the company's articles of association and disclosed in the prospectus ; or, the statement in lieu of prospectus (s. 89).

Commission and brokerage paid for placing shares is vouched by production of the application forms initialled by the persons to whom the commission has been paid.

Any commissions paid on the issued shares or debentures must be stated in every Balance Sheet (s. 90), and appear in the Annual Summary (s. 26) until the whole amount is written off.

Forfeited Shares.—Companies usually take power in their articles of association to forfeit shares for non-payment of calls.

Where the company exercises that power the auditor should see that the forfeiture is effected with due

regard to all the formalities required by the company's articles.

The amount already received on such shares will be in the nature of a profit, which may be utilised in discharging any loss arising out of re-issue. It must be noted, however, that a company cannot re-issue forfeited shares for a sum less than the amount remaining unpaid by the original holder, since to do so would, in effect, be an issue at a discount, which is contrary to the Companies Act.

Profits Prior to Incorporation.—It frequently happens that a company takes over a business as from a date prior to its incorporation.

As a company cannot make profits before it comes into existence, it follows that any profits which are made after the date from which it takes over the business to the date of incorporation, are capital profits, and should not be distributed in dividend.

Example

A company is incorporated March 31st, 1912, and takes over a business on the basis of a balance sheet, dated December 31st, 1911. The profits of the business for the year ended December 31st, 1912, are available for dividend in respect of the period from March 31st, 1912, to December 31st, 1912, but not for the period from December 31st, 1911, to March 31st, 1912.

When *stock* is not taken, it is necessary to apportion the profits for the year, and it is suggested that the following is a reasonable method of apportionment :—

(i.) The gross profit should be divided in proportion to the turnover for the two periods.

(ii.) Those items of expense which are fixed, such as rent and rates, should be divided in proportion to the time covered by the two periods.

(iii.) Those items of expense which vary with the turnover should be divided in proportion to turnover.

(iv.) In all cases where exact figures can be conveniently obtained these should be utilised.

In some businesses that have a steady trade not affected by the seasons, the net profit can be divided in proportion to time without serious error.

The profits prior to incorporation so ascertained will be kept as a permanent reserve or utilised in writing down some assets such as goodwill.

Assets such as plant and machinery, leases, etc., should not be selected for this purpose, the reason being that as these will be depreciated in the ordinary way, to write them down in this manner would have the effect of crediting the profits prior to incorporation to revenue.

Directors' Fees or Remuneration.—Directors' fees must be sanctioned by the articles of association, and the auditor should see that the amount provided in the articles is not exceeded. It should be noted that in the absence of provisions to the contrary, the amount stated in the articles is inclusive of expenses of attending meetings (*Young* v. *Naval and Military Stores*), so that travelling expenses attending meetings are not chargeable in the accounts without express sanction in the articles; nor are the directors entitled to payment of income tax on their fees by the company, where the limit of their remuneration allowed by the articles has been reached (*Boschoek Co.* v. *Fuke*).

Cost of Issuing and Obtaining the Signatures to Proxy Forms.—These expenses have been decided to be chargeable in the company's accounts (*Peel* v. *London and North Western Railway*, reversing *Studdert* v. *Grosvenor*).

Secret Commissions.—Where secret commissions are paid out of the funds of a limited company, such payments are illegal and *ultra vires* the company. In view of a recent case (*Re City of Bolivia Exploration Syndicate, Ltd.*) it appears that it is the duty of the auditor to mention the fact in his report should the nature of the payments come to his knowledge.

IX

POINTS FOR CONSIDERATION IN SPECIAL CLASSES OF AUDIT

Companies Clauses Consolidation Act, 1845—Partnerships—Stock and Cost Accounts—Assurance Companies—Banks—Building Societies — Breweries — Charitable Institutions — Collieries and Mines — Executorships—Friendly Societies—Gas Companies—Water Companies—Electric Lighting—Railways—Corporations.

COMPANIES UNDER THE COMPANIES CLAUSES CONSOLIDATION ACT, 1845

THE Companies Clauses Consolidation Act, 1845, contains certain provisions which apply to all companies formed by special Act of Parliament except when specifically amended or excluded by the special Act.

Such companies are required to keep—

(i.) Register of shareholders (s. 9).

(ii.) Shareholders' Address Book (s. 10).

(iii.) Register of mortgages and bonds (s. 45).

(iv.) Register of holders of consolidated stock (s. 46).

The company must at the first ordinary meeting in each year elect two auditors (s. 101), who must each hold at least one share and must not hold any other office in the company (s. 102). One auditor must retire each year, but is eligible for re-election.

It is the duty of the auditor to receive the accounts from the directors and to examine the same (s. 107), and

for that purpose may "employ such accountants and other persons as they think proper, at the expense of the company, and they shall either make a special report on the said accounts or simply confirm same."

The balance sheet must "exhibit a true statement of the capital, stock, credits, and property of every description belonging to the company . . . and a distinct view of the profit or loss" (s. 116). The balance sheet must be "examined by the directors or any three of their number and signed by the chairman or deputy chairman of the directors" (s. 116).

The auditors of parliamentary companies should have regard to the above provisions in addition to any provisions in the special Act.

Partnership Accounts.—In auditing the accounts of partners the auditor should consider the nature of his duties. These will vary considerably with the circumstances of the case. It is proposed to deal with the principal types in this class of audit and to bring to the notice of the student the important points in each. There are, however, a number of matters which will require attention in all cases.

The auditor should always inspect the partnership agreement where one exists, and note those matters which appear to him to have a bearing on his duties. He should note—

(i.) The manner in which profits and losses are to be shared.

(ii.) All provisions as to introducing and withdrawing capital, together with a note as to the existence or otherwise of clauses relating to interest on capital.

(iii.) The manner in which drawings are to be made and whether interest is chargeable thereon.

(iv.) The rights and limitations of partners in carrying on partnership business.

(v.) The manner in which accounts are to be produced and agreed between the partners.

Where no written agreement exists, it is suggested that the auditor should ascertain from the partners themselves the nature of their agreement, and the information obtained should be embodied in a memorandum signed by all the partners authorising the auditor to rely on the information in the audit.

Where the firm is one in which all the partners in the business are active, and the auditor is required to certify the accounts at the close of the period covered by those accounts, his duty will consist of executing an efficient general audit in addition to satisfying himself upon the following points:—

(i.) That the partners are not acting beyond the scope of their authority as limited by the Partnership Act, 1890, and the partnership agreement, without the knowledge and consent of all the partners.

(ii.) That the provisions in the agreement as to sharing profits, capital, drawings, and interest are carried into effect in the accounts.

(iii.) That no partner is drawing more out of the business than he is entitled to under the agreement without the consent of his co-partners.

It should be noted that it is incorrect to debit income tax paid direct to the Profit and Loss Account, inasmuch as this has the effect of debiting the partners

with income tax *pro rata* to profits, a result which is almost invariably incorrect. A statement should be prepared showing the basis on which the assessment is made, and this will reveal the amount of tax to which each partner is liable. These amounts should be charged to the partners' drawings accounts and credited to income tax account, the amount of income tax payable being debited to income tax account, and credited to Income Tax Commissioners. It will be seen that by this method we eliminate income tax from the Profit and Loss Account.

Where it is the custom of partners to take goods out of the business for private purposes, the auditor should obtain a list of these, signed by the partners liable. Where it is the custom to enter these transactions in the Sales Day Book as ordinary sales and to post to the debit of the partners' accounts, no further entries are necessary; but if no entry has been made each partner must be debited with his purchases and Sales Account credited.

When the audit is completed the auditor should see that the accounts are agreed between the partners in the manner required by the agreement.

Where one of the partners desires to have the accounts audited, the auditor may be called upon to conduct the audit on his behalf; indeed it is a common practice to appoint auditors on behalf of a sleeping partner. Provision for such appointments is usually contained in the articles; but the Partnership Act, 1890, provides by section 24 that in the absence of agreement, each partner has a right of access to the books, and this provision has been held to include the power to appoint an accountant

to conduct an investigation (*Bevan* v. *Webb*). It should be noted that the agreement itself can negative this right.

Where so appointed, the attitude of the auditor is necessarily changed. His duty will not be principally in maintaining *status quo* between the partners, as is the case in a simple partnership; but rather to safeguard the interest of the individual partner on whose behalf the audit is conducted.

Working from this we find that an audit on behalf of a sleeping partner will include a careful verification of all the assets, the thorough vouching of the cash payments, and ascertaining that partnership profits are duly accounted for. The auditor should pay special attention to the drawings accounts of the remaining partners, to see that they are within the provisions of the agreement. Inquiry should also be made into any expenses and charges on the firm made by each partner.

Stock and Cost Accounts.—The auditor is occasionally invited to audit the Cost Accounts of a business. This practice is common in the audit of the accounts of builders and contractors. The principal points in the audit will be :—

(i.) To vouch the goods inwards and outwards. This can be done completely if the system is sound and properly carried out. For goods inwards, invoices will be available, and for goods outwards, the requisition notes signed by the foreman on the job, also the entries in the Sales Day Book.

(ii.) To check carefully the entries in the Goods or Stores Ledger, with particular reference to

differences written off. Inquiry should be made into the cause of such differences and the information obtained noted.

(iii.) To check the balances in the Goods Ledger with the stock actually in hand as shown by the stock sheets.

(iv.) To check the postings of the wages analysis to the Cost Ledger, and also to check some portion of the detail analysis as a test.

(v.) To inquire into the adequacy or otherwise of the provision for "on cost." The auditor should take the items of expense which the "on cost" is intended to cover as shown by the Revenue Account, and also calculate the amount which would be obtained at the rate or percentage in use. The latter figure should slightly exceed the former.

(vi.) To see, as far as possible, that all direct expenses are charged to the particular job in respect of which they are incurred, and not to the general management expenses of the business.

In the majority of cases, it is impossible to conduct the audit in detail, consequently the auditor must rely to a great extent on tests of the more detail work.

The profits as shown by the Cost Accounts should be scrutinised, and any violent fluctuations inquired into with a view of ascertaining whether any portion of the cost has been omitted or wrongly debited as the case may be.

Where the Cost Accounts are designed so as to show the total profits of the business, such total should be

compared with the Revenue Account in the financial books and the difference reconciled. This reconciliation will reveal any serious defects there may be in the system of costing.

Assurance Companies.—The accounts of companies carrying on any of the following classes of business are governed by the Assurance Companies Act, 1909:—

(i.) Life assurance.
(ii.) Fire assurance.
(iii.) Accident assurance.
(iv.) Employers liability assurance.
(v.) Bond investment business.

The Act provides that assurance companies shall make up accounts in the forms given in the Act. Where the business carried on falls into more than one of the above classes, the various departments are to be stated separately in the accounts, the funds of each department being security for the policy holders in that department. A copy of the accounts is to be filed with the Board of Trade and copies sent to each shareholder.

Every assurance company must have auditors, no matter how the company is formed, and the auditors duties are as defined by—

(i.) The Companies Clauses Consolidation Act, 1845;
or (ii.) The Companies (Consolidation) Act, 1908;
or (iii.) As prescribed by the Board of Trade.

A sum of not less than £20,000 must be deposited with the Supreme Court in respect of each class of business engaged in by the company; but companies engaged in fire, accident, employers' liability, and bond investment business prior to the passing of the Act are exempt in respect of those departments.

The auditors principal duties will be—

(i.) To ascertain that all premium income is brought to credit. The Renewals Register will show the gross amount of premiums receivable, and this, less the amount of premiums discontinued (as revealed by the returned receipt forms), will, with necessary minor adjustments, give the net amount of premiums, which should agree with the actual cash received.

(ii.) To verify all investments and to see that the income therefrom is all brought to credit.

Adequate reserves should be made to cover—

(i.) Unexpired premiums.

(ii.) Premiums paid in advance, *e.g.* premiums for seven years are not infrequently paid at once subject to a discount.

(iii.) Claims both admitted and those notified but not admitted.

Banks.—Banking companies formed under the Companies Acts are governed by the same rules as to accounts and audit as any other limited company, subject to the following qualifications—

(i.) Banking companies must prepare and exhibit in their different places of business, a statement in the form prescribed by the Companies (Consolidation) Act, 1908 (s. 108).

(ii.) The Balance Sheet must be signed by the secretary or manager, if any, and *three* directors. If there are only two directors or less, all must sign (s. 113).

(iii.) If the company has branches beyond the limits of Europe, it is sufficient if the auditor is

allowed access to such copies of and extracts from the books and accounts of the branch as have been transmitted to the head office.

The duties of the auditor of a bank are perhaps more onerous than in any other class of audit, since he is under a *moral* obligation to the public to certify as to the solvency of the bank. Moreover, the volume of the transactions renders it impossible to make a detailed audit. The system of internal check, which is usually very efficient and highly developed, must be relied upon to cover a great portion of the detail. The whole of the assets should, however, be carefully verified. The cash in the tills should be counted and securities inspected immediately on the close of the day of balancing. In the case of banks having a large number of branches this is impossible, but it is suggested that the auditor pay surprise visits to these branches during the year for the purpose of counting the cash in the tills.

The overdrafts allowed to customers should be inspected together with the securities therefor. Interest should never be taken credit for on balances which are bad or doubtful. Where the auditor is convinced that certain balances are bad or doubtful he should insist on adequate reserves being made against them. The student is reminded of the case of the London and General Bank referred to on p. 99.

As many of the customers' Pass Books as are obtainable should be compared with the ledgers. It is advisable that the auditor take charge of the Pass Books as soon as they are received over the counter, and not after they have passed through the hands of any of the staff.

The accounts in the General Ledger should be

exhaustively checked with the summaries taken from the subsidiary books.

The amount of the rebate on bills discounted should be tested with a view of proving the adequacy of this reserve.

Where banks have the right of note issue, no part of the company's own notes should be included in the cash balance (*Re Dumbells Banking Co., Ltd.*), since this will give the Balance Sheet a false appearance of stability.

In connection with the audit of bank accounts there arises the question of secret reserves. The fact that the majority of banks have such a reserve is an argument advanced in favour of their retention. It happens that an unfortunate custom has rendered necessary, proceedings which cannot but be regarded as unsatisfactory, since the public in judging the stability of a bank are inclined to believe that there is something in the background in addition to that which is revealed by the accounts, whether that "something" actually exists or not. To this extent, therefore, a secret reserve is necessary to a bank. It should be noted, however, that the reserve is "secret" only as to the amount, and not as to its existence; indeed, as regard the latter it may be termed, paradoxically perhaps, an "open secret."

The secret reserve should not be raised by the total elimination of an asset from the Balance Sheet. If an asset exists it must be disclosed (*Newton* v. *Birmingham Small Arms Co.*), so that a secret reserve should be created only by writing *down* the assets.

Breweries.—The accounts of breweries present two points for special consideration—

(i.) Tied houses.

(ii.) Barrels in the hands of customers.

As brewers are more concerned with the likelihood of their tenants being able to get trade than with their financial means, it is obvious that loans made to such tenants will require special attention in ascertaining the value of such accounts. A further point bearing on this is that the brewers' loss may even exceed the amount of the loan because of liability on guarantees to outside lenders.

The amounts paid to the Compensation Fund under the Licensing Consolidation Act, 1910, should be charged to revenue; but any amount received from the fund should all be credited to capital, unless it is clear that a realised profit has been made on the transaction, in which case revenue may be credited with the profit. It has been contended in some quarters that this principle is unsound, on the ground that each licence taken away increases the value of the surrounding houses, and in consequence, the value of the whole remains fairly constant. Following this argument we have the alternative of placing both sums paid to and received from the fund to capital or both to revenue. The more conservative policy first indicated is, however, recommended in view of—

(i.) The tendency of modern legislation.

(ii.) The enormous watered capital already sunk in tied houses.

(iii.) The reduction in the number of tied houses cannot be relied upon to (and does not as a matter of fact) increase the value of the remainder to a like extent.

Barrels in the Hands of Customers.—The total amount charged to customers for barrels on hand should be ascertained and the amount discounted at a rate sufficient

to reduce the balance sheet figure to cost, less a sum sufficient to put the barrels in repair.

Building Societies.—The accounts of building societies are governed by the Building Societies Acts, 1874 and 1894.

The accounts are to be made up in the form prescribed by the Act of 1894, which contains a

(i.) Receipts and Payments Account.

(ii.) Revenue and Expenditure Account.

(iii.) Liabilities and Assets Account (the Balance Sheet).

A copy must be filed with the Registrar of Friendly Societies.

Two auditors must be appointed, one of whom must be a person who publicly carries on business as an accountant, and they must attest the annual account, stating whether it is "correct, duly vouched, and in accordance with law," and shall certify that they have "actually inspected the mortgage deeds and other securities belonging to the society, and shall state the number of properties in respect of which deeds have been produced and actually inspected by them."

The auditor in inspecting the deeds should satisfy himself that—

(i.) The properties are actually transferred to the society.

(ii.) The charge should not be subject to a prior mortgage, since the Act of 1894 prevents any society from lending on a second or subsequent mortgage (s. 13).

(iii.) The last receipt for fire assurance premiums should accompany the policy and the deeds.

It has been suggested that the auditor may minimise the labour involved in inspecting the deeds by sealing the deeds relating to each mortgage in separate packets, so that in subsequent years he may pass those deeds as correct provided the seal is unbroken, taking a few at random as a test to see that the packages have not been tampered with. Whether this is a sufficient compliance with the Act is open to question.

The books of the society should be compared with the members' pass books. In doing this, the auditor will take all precautions to see that he has produced to him the actual pass books used by the members, and for this purpose should receive as many as possible over the counter *himself*.

The borrowing powers of a building society are limited by s. 15 of the Act of 1874 to two-thirds of the amount secured to the society by mortgages from its members.

Charitable Institutions.—In the audit of accounts of charities attention is called to the serious danger of misappropriation of income. Numbered counterfoil receipt books should be kept and checked by the auditor with the cash receipts as shown by the Cash Book. All spoiled receipt forms should be retained, so that the whole of the forms will be accounted for. In addition, a list of subscriptions and donations should be made and checked by the auditor, copies printed and sent to all subscribers and donors.

Where the institution receives income from investments, any income tax deducted therefrom should be recovered from the Inland Revenue Authorities, since charitable institutions are exempt from the income tax.

The expenditure calls for little *special* consideration. Care should, however, be taken to see that expenditure incurred is of such a nature as is incidental to the objects of the institution.

Attention is called to the form in which the accounts are presented. There is no reason why the accounts of charities should not conform to the rules of accountancy any more than any other undertaking, though there is usually a lamentable slackness in this direction. A Receipts and Payments Account should be called a Receipts and Payments Account and not a "Balance Sheet," as is frequently the case. In a small institution a Receipts and Payments Account is usually sufficient, but in the case of large hospitals, sanitoria, asylums and the like, an Income and Expenditure Account and Balance Sheet should be presented. It should be noted that institutions receiving grants from the King Edward VII., Hospital Saturday and Sunday funds are required to present accounts in a uniform form.

Collieries and Mining Companies.—The accounts of mining companies have received considerable attention since the decision in *Lee* v. *Neuchatel Asphalte Co.*, the reason being that this case brought to the notice of the investing public the fact that such companies have a strong tendency to pay dividends where in fact no *true* profits have been earned, thus rendering the investment of an extremely speculative nature.

The auditor must pay special attention to the capital expenditure. The first cost of sinking and shafting may be capitalised, but provision should be made for writing this off before the mine is worked out or before the lease (if any) expires. Developments of the underground

workings and timber for propping should always be charged to revenue, as being part of the cost of raising the mineral.

Machinery (including crushing plant), engines, boilers, weigh-bridges, railway waggons, should be written down in the usual manner applicable to such assets. By this means only can the financial soundness of the undertaking be maintained.

The wages account is the largest item of expenditure, and should be carefully investigated by the auditor. He should make himself acquainted with the system of payment of wages, and satisfy himself as to its soundness. In colliery accounts the total wages may usually be tested with the total output, since the greater portion of the wages paid is calculated on a piece-work basis at so much per ton. The deductions from the wages are in colliery accounts rather numerous, and the auditor should satisfy himself that these are properly appropriated, *e.g.* deductions for rents of cottages should be debited to wages and credited to rents receivable account.

Wages paid in respect of capital expenditure should be carefully investigated, full details being obtained of the nature of the work done.

The Royalty Account should be checked in total with the output by calculation of the amount which should be paid on the actual output. Where short-workings appear in the Balance Sheet, the auditor should refer to the lease to satisfy himself that they are recoupable, and should also consider whether there is a reasonable prospect of their being received in the future.

Where the company holds waggons on the hire-purchase system the auditor should satisfy himself that

(i.) The instalments are apportioned, charging revenue with the interest on the cash value, the balance of the instalment being capitalised.

(ii.) Proper depreciation is charged to revenue. This should be calculated on the amount of the cash value of the waggons.

(iii.) A note is made in the Balance Sheet that the waggons are on the hire-purchase system.

Foreign Mines.—It is the custom of many large foreign mining companies to have the accounts at the mine audited locally. In such a case the auditor may rely on the accounts as certified by the local accountant.

Where the whole accounts are to be audited in this country, the auditor will inspect the returns sent to the head office by the local manager. These returns should be supported by proper vouchers and documents together with full explanations of extraordinary items, *e.g.* details of capital expenditure. The auditor will use these documents in vouching the returns.

Having satisfied himself as to the general accuracy of the returns, the auditor should then see that they are properly incorporated in the books at the head office.

The transactions at the head office will usually be confined to financing the undertaking, share transfers, and the like. These call for no special comment, as they fall within the general scope of the audit of any company.

Executorship and Trust Accounts.—The accounts of executors and trustees should be audited in detail. As the authority of executors or trustees is obtained from

the will or the trust instrument, as the case may be, it will be the first duty of the auditor to make himself acquainted with all the provisions therein contained, and he should have them constantly before him during the audit.

The audit programme should include

(i.) Vouching the cash account in detail, both debit and credit sides.

(ii.) Checking all the apportionments between capital and income.

(iii.) Scrutinising the investment accounts to see that all interest and dividends due on investments have actually been received.

(iv.) Examining the securities representing the investments, and seeing that they are authorised by

(*a*) the trust instrument, or

(*b*) the Trustee Act, 1893, or the Colonial Stock Act, 1900.

(v.) Ascertaining whether the income is being applied in accordance with the trust instrument.

In addition the audit will include the usual routine work of reconciling the bank balance and checking additions and postings.

Where it is found impossible to obtain the appointment of an auditor with the consent of all parties interested in the trust, any trustee or beneficiary has the right of requiring that the accounts of the trust be audited periodically.

Application may be made for this purpose by any trustee or beneficiary to the public trustee. Notice of the application must be given to all other trustees and beneficiaries. If, within three months of this notice, no

auditor is appointed by agreement of the parties, the public trustee will audit the accounts, or appoint some fit person to conduct the audit in his stead. Where the auditor is appointed by agreement of the parties his remuneration is fixed by agreement with the parties ; but if appointed by the public trustee his remuneration is in the discretion of the public trustee. The expenses of the audit are usually chargeable on the estate, but the public trustee may direct that they be borne by the applicant or by the trustees or by both (Public Trustee Act, 1906).

The auditor so appointed has the right of access to all books, accounts, vouchers, securities, documents of title relating to the trust, and to all information and explanation as may be necessary for the conduct of the audit. On completion of the investigation, the auditor must forward a copy of the accounts to the applicant and every trustee. With the accounts he must forward a report and certificate signed by him to the effect that "the accounts exhibit a true view of the state of the affairs of the trust, and that he has had the securities of the trust fund investments produced to and verified by him, or (as the case may be) that such accounts are deficient in such respects as may be specified in the certificate."

Friendly Societies.—Societies formed under the Friendly Societies Acts are required to submit their accounts to either a "public" auditor or to two or more other persons (Friendly Societies Act, 1896, s. 26).

The accounts are to be made up in the form of an "annual return," which must be filed with the Registrar of Friendly Societies (s. 27). It is the duty of the auditor or auditors to "either sign the annual return as found by

them to be correct, duly vouched, and in accordance with law, or specially report to the society or branch in what respects they find it incorrect, unvouched, or not in accordance with law" (s. 26).

The auditor should carefully study the provisions of the Friendly Societies Act, 1896, together with the society's special rules with regard to investments, loans to the society and assurances, and to see that the trustees do not act beyond these powers.

In connection with friendly societies, attention is called to s. 72 of the Finance (1909–10) Act, 1910, whereby the exemption from tax granted by the Income Tax Acts is extended to any registered society which is restricted by Act of Parliament or its own rules from assuring to any person a sum exceeding £300 gross or £52 a year annuity.

Gas Companies.—Attention is called to the Gas Works Clauses Acts, 1847 and 1871. The auditor should see that the provisions of these Acts, so far as they relate to the accounts, are complied with, subject to the provisions of the special Act of the company.

Subject to any provisions in the special Act, the profits of the company may be applied in—

(i.) Paying a dividend at a rate not exceeding ten per cent. per annum on the paid-up capital. This dividend is cumulative, so that deficiencies of previous years may be made up subsequently, although the actual dividend exceeds ten per cent. for the year.

(ii.) A "reserved fund" may be raised not exceeding one-tenth of the nominal capital. This fund must be invested.

(iii.) When the full dividend and reserve has been reached the gas rate must be reduced, in order to keep the profits as nearly equal to the maximum dividend as possible.

The accounts are to be made up to December 31st in each year in the prescribed form and forwarded to the local authority before March 31st following. The accounts are on the double account system, so that the auditor will need to exercise the greatest care in dealing with additions to capital. Where a depreciation fund is raised the auditor should see that the amount is adequate and is invested.

The bulk of the income will be from gas rentals. The additions of the Gas Rentals Book should be checked and the totals verified by calculating the amount which should be received from the total consumption of gas. This figure less allowances (which should be carefully checked) will approximate to the cash received after adjusting the opening and closing balances.

Water Companies.—The Waterworks Clauses Act, 1847, contains similar provisions relating to division of profits as the Gas Works Clauses Act, 1847.

The audit has the same characteristics as that of a gas company, but there is no statutory form of accounts. It is customary to make up accounts in the form given in the Gas Works Clauses Act, 1871.

Electric Lighting Companies.—The audit of the accounts of electric lighting companies follows closely on the lines of that of gas companies accounts. Accounts are made up on the Double Account System annually to December 31st in the prescribed form and forwarded to the Board of Trade on or before March 25th following.

Attention is called to the peculiarity of the General Balance Sheet in the prescribed form. The *totals* of the Income and Expenditure on Capital Account must be stated and not the balance, as is usual in accounts kept on the Double Account System (Electric Lighting Act, 1882, s. 9).

The accounts are to be audited by an auditor appointed by the Board of Trade. The auditor has the right of access to all necessary books, vouchers, and information and his report is to be attached to the accounts. His remuneration is fixed by the Board of Trade, and is payable by the company (Electric Lighting Act, 1899, s. 6).

Railway Companies.—Railway companies' accounts are subject to the provisions of the Railway Companies Acts, 1867 to 1911, and the Companies Clauses Consolidation Act, 1847.

The Railway Companies Act, 1867 (s. 30), provides that "no dividend shall be declared until the auditors have certified that the . . . accounts proposed to be issued contain a true statement of the financial condition of the company and that the dividend proposed to be declared is *bonâ fide* due thereon after charging the revenue . . . with all expenses which ought to be paid thereout in the judgment of the Auditors." There is no need for the auditors to be shareholders of the company, and the Companies Clauses Consolidation Act, 1847, is amended with regard to railway companies to that extent (Regulation of Railways Act, 1868, s. 11).

The accounts are to be made up in accordance with the rules given in the Railway Companies (Accounts and Returns) Act, 1911. They are to be—

(i.) Made up in the form given in the Act.
(ii.) Made up to December 31st in each year.
(iii.) Signed by the chairman and deputy chairman.
(iv.) Six copies to be filed with the Board of Trade.
(v.) Statements relating to capital and loans and the General Balance Sheet to be filed with the Registrar of Companies.

Railway companies are by the same Act relieved from the requirement imposed upon them by the Regulation of Railways Act, 1868, to prepare half-yearly accounts and are allowed to declare *interim* dividends without making up *interim* accounts.

It is well known that a number of British Railways carry a large volume of watered capital. In view of this fact it will be seen that the auditor must exercise the greatest care in dealing with additions to capital. If in doubt he should lean towards charging the expense to revenue rather than to capital.

Renewals is an important factor in the accounts of railways, and the student is referred to the chapter on Depreciation on this matter.

In connection with the detail work, the auditor is entitled to rely on the work of the company's own audit staff, contenting himself with vouching the expenditure and verifying totals of income. For this latter purpose he will find the Traffic Returns and the Returns of the Railway Clearing House useful.

Municipal Corporations.—The Municipal Corporations Act, 1882, s. 25, provides for the appointment of three borough auditors, two elected by the burgesses called Elective Auditors, and one nominated by the Mayor called the Mayor's Auditor. Members of the council, the

town clerk, or the treasurer may not occupy the position of Elective Auditor, but the Mayor's Auditor must be a member of the Council. In practice it is usual to appoint qualified accountants to conduct a professional audit, though there is no provision for such appointments in the Act.

The accounts are to be made up and audited half-yearly and published, and filed with the Local Government Board annually. The account required by the Local Government Board is a return of the "receipts and expenditure of the municipal corporation for each financial year." There is no prescribed form.

It is the duty of the borough auditors to audit this account, which must be produced to them with the necessary vouchers and papers within a month of the end of the half year.

The duty which the accountant is usually called upon to perform is that of conducting a professional audit. A detailed audit is usually impossible, and in consequence the great portion of his time will be given to the consideration of the larger questions of principle. In respect of the trading departments, his duty will follow much upon the same lines as if the undertakings were owned by outside companies.

The auditor should pay special attention to the Sinking Funds; the amount actually invested is not so important a factor as the present value of the investment and the prospects of it being adequate to cover the loan when the time for repayment is reached. It is the custom of many corporations to invest the sinking fund of one department in the loans of another, a practice which has been severely criticised in the past. It is not

within the scope of this book to consider the advisability or otherwise of this proceeding, but it is suggested that the auditor will need to exercise the greatest care in dealing with these loans and also in auditing the capital expenditure for which purpose the loans are raised, having in view the fact that the corporation will have ready means of raising money out of the sinking funds. The auditor should see that the directions of the Local Government Board with regard to loans, capital expenditure, and sinking funds are being duly carried out.

It is preferable that the published accounts take the form of an Income and Expenditure Account and General Balance Sheet. The majority of corporations adopt this plan, and in addition give the accounts of each department.

Depreciation is usually ignored in the accounts on the ground that the annual sinking fund contribution renders unnecessary any further charge to revenue in respect of loss or depreciation of fixed assets. Though this principle is obviously weak and unsatisfactory, few corporations have seen fit to depart from it, and the auditor must be prepared to accept the accounts without any provision being made therein for depreciation.

X

INVESTIGATIONS

Investigations on Behalf of an Intending Purchaser or an Incoming Partner

In investigations on behalf of an intending purchaser of a business, the auditor should at once realise the position of the vendor. It will be seen that it is to the interest of the vendor to make the accounts show as favourable a position as possible.

It is not suggested that the vendors of businesses are in the habit of intentionally producing accounts which are incorrect, but it will be well for the auditor to have these matters in mind in making his investigation.

In addition the following particular points on which the auditor should satisfy himself, are suggested :—

(1) *In the Profit and Loss Account.*

(*a*) The sales should be scrutinised with a view of ascertaining whether they are *bonâ fide* and not unduly inflated during the period immediately preceding the sale, as compared with previous years.

(*b*) Care should be taken to see that all invoices are included up to the date of the balance sheet. A scrutiny of all the invoices subsequent to the balance sheet would be an advantage in this connection.

(*c*) The expenses should not greatly vary from year to year. A heavy reduction in the last year

should give rise to suspicion, particularly if the reduction be in the direction of repairs and maintenance of fixed assets. The reader will note also that where the vendor is contemplating selling the business, he may find it to his advantage to pay the expenses privately with the object of raising the price of the business.

(*d*) All profits and expenses not connected with the business and which will not be continued in the future may be eliminated from the accounts.

(*e*) Profits of a speculative nature should, at least, be shown separately.

(2) *In the Balance Sheet.*

(*a*) A close watch should be kept on the debtors' balances. Statements should be sent out to all trade debtors. It is a good plan to wait until such time has elapsed as will allow a fair portion to be paid.

(*b*) Stock-taking statements should be inspected for as many of the creditors as possible.

(*c*) A reasonable amount of depreciation should be written off the fixed assets.

(3) *Generally the Auditor should endeavour to advise his clients on:*

(*a*) The adequacy of the rate of gross profit on turnover.

(*b*) Whether the expenses are sufficiently small to allow a reasonable return on the capital employed.

(*c*) As to the amount of capital required to continue

the business. If, for example, the capital to be introduced will only be sufficient to clear the more pressing claims against the business, it will be impossible to continue with success, and it would be well for the auditor to satisfy himself on the point.

The auditor's liability for the value of stock in investigations appears to be similar to that of an auditor of a company, *i.e.* he can rely on the certificate of a responsible official (*Squires Cash Chemists* v. *Ball, Baker & Co.*).

The Certificate of Profits to be Published in the Prospectus of a New Company

In making an investigation of a business which is to be taken over by a limited company, the auditor must be prepared to have the certificate published in a prospectus. In certifying profits, therefore, under such circumstances he is under a great responsibility, the more so as he must, whilst acting fairly on behalf of his clients, the promoters, produce a report on which the general public will not be misled. He will be well advised to report entirely on facts, and should abstain from giving an opinion as to prospects even if asked to do so.

His investigation should be most carefully conducted, having regard to the points enumerated in the previous form of investigation discussed, and should not be confined to the last year's trading, but cover a period of, say, three or five years. In his report he should not give average profits, turnover, expenses, etc., but the

actual figures for each year covered by the investigation, adding average and percentage figures at his discretion.

This rule cannot be too strongly emphasised, for although averages are very useful data, it should be noted that heavy fluctuations may show an average giving the impression of stability where such may be far from the truth. Any attempts to equalise profits should be guarded against, *e.g.* keeping back invoices in a bad year and bringing them into the next more successful year.

Fraud in Accounts

An auditor is not responsible if he fails to detect deep-laid schemes of fraud: he is "a watch dog and not a bloodhound" (*Re Kingston Cotton Mills Co., Ltd.*). Such is the auditor's legal position, so that he must be on the alert, and be ready to give the warning in case of danger.

No definite rules can be laid down with regard to the detection of fraud—the variety of methods renders this impossible.

A well-organised audit will certainly close many loopholes, and a stringently conducted system of internal check will close many more. The more common openings, such as wages, petty cash, and the like have already been discussed. There are, however, a few common types to which it would be well to draw attention.

Where one cashier has control of two cash accounts, *e.g.* the manager of a ring of single ship companies, he has many opportunities of covering defalcations where the accounts are made up at different dates.

Let us assume that Z is the cashier of the "A" company, making up its accounts to the end of December,

and the "B" company to the end of March. Under these circumstances it will be a simple matter for Z to make up defalcations in the "A" company by drawing from the "B" company, and to replace the funds when the audit is completed, and thus be able to produce the correct balances in the "B" company's accounts when the time comes for this audit.

Where the same auditor acts for both companies, he should consider this possibility and examine the cash and bank balances of both simultaneously, and up to the same date.

Misappropriation by a cashier will usually be detected by a surprise audit of the Cash Account, provided the cash is counted immediately on arrival.

Where sums have been paid by customers and not accounted for by the cashier, the need for concealing the fraud will be apparent to the defaulter, and the auditor will be well advised in consequence to make a careful inquiry into the *returns and allowances* to customers and also to *bad debts.*

Where suspicion has been aroused, this inquiry should be most rigorously carried out in order to ascertain the extent to which frauds could have been covered in this direction. A careful examination of the overdue accounts in the Sales Ledger will then reveal any shortage which may exist.

On investigating accounts which have been the subject of defalcations, the auditor should proceed with the utmost discretion, particularly as it is usually not advisable to reveal the circumstances to the customers. Such an investigation will include an examination of returns, bad debts, and ledger balances as set out

above. In addition, statements should be immediately prepared, checked and sent out to all customers within the area covered by the frauds, under the auditor's personal supervision, showing the customer's indebtedness *as stated in the ledgers.* The auditor will use his own discretion as to whether the customer be requested to communicate his agreement or otherwise with the correctness of the statement. In any case, the letter should be diplomatically worded so as to convey no hint of the true state of affairs.

With regard to the accounts misappropriated, the customer should only be credited on production of a receipt from the defaulter.

The duty of an auditor who discovers that his client's business is fraudulent or illegal has been widely discussed recently. There can be no doubt that he should immediately disassociate himself from the business, indeed the Institute of Chartered Accountants insist that their members must not be connected with any business which is improper in the least degree. Whether he should go further than this is an extremely thorny question.

Let us assume that his client is a person, who in the interest of justice and commercial morality should be immediately prevented from proceeding further in his business, we find that the auditor's duty *quâ* individual is in direct conflict with his professional responsibilities.

The question appears to depend entirely on the degree of impropriety in the client's transactions. The auditor's position is at the best an unenviable one. He is in possession of information which he has received as a professional man, in trust, and he should not betray that trust unless the circumstances leave him no alternative.

XI

FORMS OF PUBLISHED ACCOUNTS

Assurance Companies

An example is given on pp. 141 to 144 of the accounts in the form prescribed by the Assurance Companies Act, 1909.

The distinctions between the "Revenue Account in respect of Life Assurance Business" and the "Revenue Account in respect to Fire Insurance Business" should be noted. The former is a receipts and payments account, the profit in the Life department only being ascertained at each quinquennial valuation. The division of the Life Assurance business into "Business within the United Kingdom" and "Business out of the United Kingdom" should also be noted.

The Revenue Account in respect of Fire Insurance Business, and in all the departments other than life, is a true Revenue Account designed to show the profit on the year's working. The amount of the Fire Insurance Fund is the amount reserved which is estimated to cover the unexpired portions of the premiums *plus* in this particular case, an additional reserve for contingencies.

In the Balance Sheet it will be seen that the investments are required in considerable detail, also that the method of valuation of the securities is given. This statement is required by the Act.

REVENUE ACCOUNT OF THE RUBY ASSURANCE COMPANY, LIMITED, FOR THE YEAR ENDING DECEMBER 31ST, 1913, IN RESPECT OF LIFE ASSURANCE BUSINESS.

	Business within the United Kingdom.	Business out of the United Kingdom.	Total.		Business within the United Kingdom.	Business out of the United Kingdom.	Total.
	£	£	£		£	£	£
Amount of life assurance fund at the beginning of the year	—	—	6,600,000	Claims under policies paid and outstanding :— By death	216,300	79,200	295,500
Premiums	323,500	190,500	514,000	By maturity	123,500	32,200	165,700
Consideration for annuities granted	18,100	800	18,900	Surrenders, including surrenders of bonus	56,500	24,200	80,700
Interest, dividends, and rents £273,000				Annuities	17,300	300	17,600
Less income tax thereon 14,600	—	—	258,400	Bonuses in cash	1,000	300	1,300
Fees	—	—	300	Bonuses in reduction of premiums	1,800	100	1,900
				Commission	16,000	13,800	29,800
				Expenses of management	—	—	44,200
				Amount of life assurance fund at the end of the year, as per Balance Sheet	—	—	6,754,900
£	—	—	7,391,600	£	—	—	7,391,600

Revenue Account of the Ruby Assurance Company, Limited, for the Year ending December 31st, 1913, in respect of Fire Insurance Business.

	£	£		£	£
Amount of fire insurance fund at beginning of the year:—			Claims under policies paid and outstanding		1,925,200
Reserve for unexpired risks	1,515,300		Commission		604,400
Additional reserve	784,700	2,300,000	Expenses of Management		776,100
			Contributions to fire brigades		8,500
Premiums		3,895,000	Surplus carried to Profit and Loss		580,800
Transferred from Profit and Loss		500,000	Amount of fire insurance fund at the end of the year as per Balance Sheet.		
			Reserve for unexpired risks being 40 per cent. of the premium income for the year	1,558,000	
			Additional Reserve	1,242,000	2,800,000
		£ 6,695,000			£ 6,695,000

PROFIT AND LOSS ACCOUNT OF THE RUBY ASSURANCE COMPANY, LIMITED, FOR THE YEAR ENDING DECEMBER 31ST, 1913.

	£	£		£
Balance of last year's account		1,007,050	Dividends and bonuses to shareholders .	400,000
Interest and dividends not carried to other accounts	274,675		Transfer to Fire Account	500,000
Less income tax thereon .	11,925			
		262,750		
Profits realised on Fire Insurance Business .		580,800	Balance as per Balance Sheet. . . .	950,600
	£	1,850,600	£	1,850,600

BALANCE SHEET OF THE RUBY ASSURANCE COMPANY, LIMITED, ON THE 31ST DECEMBER, 1913.

LIABILITIES.	£	£	ASSETS.	£
Shareholders' capital paid up	2,000,000		Mortgages on property within the United Kingdom	880,150
Life assurance and annuity funds	6,754,900		Do. do. out of the United Kingdom	350,600
Fire insurance fund	2,800,000		Loans on parochial and other public rates	1,100,000
Profit and loss account	950,600		Do. Company's policies within their surrender values	
		12,505,500		1,285,000
Claims admitted or intimated but not paid			Investments :	
			Deposit with the High Court (£50,000 Consols)	39,000
Life assurance	62,000		British Government securities	385,000
Fire insurance	205,000		Municipal and county securities, United Kingdom	77,000
		267,000	Indian and Colonial Government securities	1,475,000
Commission and other outstanding liabilities			Do. provincial securities	280,000
			Do. municipal do.	370,000
Life assurance	10,700		Foreign Government securities	310,000
Fire insurance	24,500		Do. provincial securities	105,000
		35,200	Do. municipal do.	408,000
			Railway and other debentures and debenture stocks—Home and Foreign	3,150,000
			Railway and other preference and guaranteed stocks	1,385,000
			Do. ordinary stocks	17,000
			Freehold ground rents	480,000
			House property	305,000
			Life interests	85,000
			Reversions	45,000
			Agents' balances	10,300
			Outstanding premiums	151,000
			Do. interest, dividends, and rents	105,900
			Cash : In hand and on current account	8,750
	£	12,807,700	£	12,807,700

NOTE.—In this Balance Sheet the Stock Exchange securities stand at or below the value at the date of the last quinquennial valuation, or at or below cost in the case of any acquired since that date. Upon a revaluation on the date of this Balance Sheet the market values were found to exceed the Balance Sheet values in the aggregate.

Banking Companies

The student should study the following points in connection with the published accounts of the London County and Westminster Bank, Limited.

The "Acceptances for Customers" and "Endorsements on Bills Negotiated" are stated on both sides of the Balance Sheet. This method of treating this particular type of contingent liability is followed by all the leading bankers. It should be noted that the contingent liability on guarantee is stated as a memorandum, thus following the general practice.

The Liability side of the Balance Sheet shows an "Investment Depreciation Account," thus affording an example of the method advocated on p. 66.

The "Rebate on Bills not Due" is stated separately in the Profit and Loss Account, the item appearing also in the Balance Sheet as a reserve. It should be noted that the previous year's reserve is absorbed in the item of £3,748,244 2*s.* 11*d.* on the credit side of the Profit and Loss Account.

LONDON COUNTY AND

BALANCE SHEET,

Liabilities.	£	s.	d.
Capital—Subscribed £14,000,000			
700,000 Shares of £20 each, £5 paid	3,500,000	0	0
Reserve	4,000,000	0	0
Investments Depreciation Account	250,000	0	0
Current and Deposit Accounts	85,394,689	18	2
Circular Notes, Letters of Credit, Commission Loans, and other Accounts, including provision for Contingencies.	2,819,251	19	0
Acceptances for Customers	7,090,185	6	1
Endorsements on Bills Negotiated	565,882	17	1
Rebate on Bills not due	99,708	18	4
Profit and Loss Balance, as below	528,519	11	6
This statement does not include the Bank's liability under its guarantee to the Yorkshire Penny Bank, Limited, for £223,214			
	£104,248,238	10	2

GOSCHEN,
WALTER LEAF, } *Directors.*
C. J. HEGAN,

AUDITORS'

We have examined the above Balance Sheet and compared it with the Books at Lothbury
We have verified the Cash in hand at Lothbury and Lombard Street and at the Bank of
and Short Notice, and those representing the Investments of the Bank.
We have obtained all the information and explanations we have required, and in our
the state of the Company's affairs according to the best of our information and the explana-

LONDON, 19*th January*, 1914.

WESTMINSTER BANK, LIMITED.

31ST DECEMBER, 1913.

Assets.	£	s.	d.	£	s.	d.
Cash—						
In hand and at Bank of England	13,757,106	19	1			
At Call and Short Notice	12,382,899	2	7			
				26,140,006	1	8
Bills Discounted				15,800,195	8	10
Investments—						
Consols (of which £1,390,210 is lodged for Public Accounts), and other Securities of, or guaranteed by the British Government .	5,364,785	12	9			
Indian Government Stock, and Indian Government Guaranteed Railway Stocks and Debentures	1,254,470	5	4			
Colonial Government Securities, British Corporation Stocks, and British Railway Debenture Stocks	656,043	11	0			
Other Investments	1,438,217	9	9			
				8,713,516	18	10
London County and Westminster Bank (Paris), Limited—						
4,000 £20 Shares—fully paid . . . . } 16,000 £20 Shares—£7 10*s.* paid . . . }				200,000	0	0
Advances to Customers and other Accounts .				44,089,225	12	7
Liability of Customers for Acceptances, as per contra				7,090,185	6	1
Bills Negotiated, as per contra				565,882	17	1
Bank and other Premises (at cost, *less* amounts written off)				1,649,226	5	1
			£	104,248,238	10	2

F. J. BARTHORPE, *Head Office Manager.*
J. W. BUCKHURST, *Country Manager.*
T. J. CARPENTER, *Chief Accountant.*

REPORT.

and Lombard Street, and the certified returns received from the Branches.
England and the Bills Discounted, and examined the Securities held against Money at Call

opinion the Balance Sheet is properly drawn up so as to exhibit a true and correct view of
tions given to us, and as shown by the Books of the Company.

FRED. JOHN YOUNG, F.C.A., } *Auditors.*
G. E. SENDELL, F.C.A., }

LONDON COUNTY AND WESTMINSTER BANK, LIMITED.

PROFIT AND LOSS ACCOUNT.

Dr.	£	s.	d.	Cr.	£	s.	d.
To Interest paid to Customers	1,234,093	17	9	By Balance brought forward from 31st December, 1912	155,495	1	9
,, Salaries and all other expenses, including Income Tax and Auditors' and Directors' Remuneration	1,219,541	17	1	,, Gross Profit for the year, after making provision for Bad Debts and Contingencies, and including Rebate brought forward from 31st December last	3,748,244	2	11
,, Rebate on Bills not due carried to New Account	99,708	18	4				
,, Interim Dividend of 10⅝ per cent. paid in August last	371,875	0	0				
,, Investment (Depreciation) Account	250,000	0	0				
,, Bank Premises Account	100,000	0	0				
,, Provident Fund Capital Account	100,000	0	0				
,, Further Dividend of 10⅝ per cent., payable 2nd February next (making 21¼ per cent. for the year) £371,875 0 0 ,, Balance carried forward . 156,644 11 6	528,519	11	6				
	£3,903,739	4	8		£3,903,739	4	8

Building Societies

The accounts are made up in the form prescribed by the Building Societies Act, 1894.

The Statement showing the "operations of the year," or "Revenue and Expenditure Account," is an analysis of each of the headings in the "Liabilities and Assets Account."

Commencing with the opening balance, the additions during the year are stated separately and similarly with the contra items set against them, so that the first two columns will equal the last two.

It will be noted also that the Statement is divided into two parts, the first dealing with the liabilities and the second with the assets side.

The first and last columns of the first part will equal the first and last columns of the second part respectively, since they contain all the opening and closing balances.

The attention of the student is drawn to the certificate at the foot of the Liabilities and Assets Account. There is no special form of certificate prescribed by the Act, but the example given meets the requirements.

Dr. LIABILITIES AND ASSETS

	Principal.			Interest.					
	£	s.	d.	£	s.	d.	£	s.	d.
To liabilities to holders of shares, viz.—									
Investment shares	57,628	1	5	6,490	7	5			
Preferential shares	35,150	0	0	594	5	11			
Total	92,778	1	5	7,084	13	4	99,862	14	9
To liabilities to depositors and other creditors, viz.—									
For deposits payable upon various times of notice, viz.—	34,447	18	11	607	1	10	35,055	0	9
To undivided profit (including reserve funds, but not including prospective interest), viz.							7,889	0	2
£							142,806	15	8

We the undersigned, H. Brown, being a person who publicly carries on the business of an
the duly appointed Auditors of the above-mentioned Society, do hereby attest the foregoing
law, and we certify that we have, and each of us has, at this audit actually inspected the Mortgage
mortgage to the Society, referred to in the foregoing Accounts and Statements.

Dated this 10th day of February, 1914.

ACCOUNT (STOCK ACCOUNT). Cr.

	Principal. £	s.	d.	Interest accrued (not prospective). £	s.	d.	£	s.	d.
By balance due or outstanding on mortgage securities, not including prospective interest, viz.—									
Mortgages from members where the repayments are not upwards of twelve months in arrears and the property has not been upwards of twelve months in possession of the society—									
On 68 mortgages where the debt does not exceed £500	18,098	7	8	660	0	5			
On 37 mortgages where the debt exceeds £500 and does not exceed £1000	26,057	18	1	1,122	11	2			
On 34 mortgages where the debt exceeds £1000 and does not exceed £3000	48,537	18	2	1,896	7	8			
On 4 mortgages where the debt exceeds £3000 and does not exceed £5000	14,792	12	2	669	12	6			
On 2 mortgages where the debt exceeds £5000 as shown by Part I. of the schedule	10,390	10	4	463	12	0			
Total of mortgages available under sect. 14 of the Act of 1894	117,877	6	5	4,812	3	9			
On 1 mortgage on property of which the society has been upwards of twelve months in possession, as shown by Part II. of the Schedule	1,216	12	8	74	7	0			
On — mortgages where the repayments are upwards of twelve months in arrear, and the property has not been upwards of twelve months in possession of the society as shown by Part III. of the Schedule		*Nil*			*Nil*				
Total number of properties mortgaged to the society—146.									
Total	119,093	19	1	4,886	10	9	123,980	9	10
By other assets—									
Amount invested in the Funds					*Nil*				
Amount invested in freehold property at 4 %				15,000	0	0			
Deed and book safes				20	0	0			
Office furniture				30	0	0			
Copies of rules				9	13	0			
Cash in bank				3,766	12	10	18,826	5	10
						£	142,806	15	8

Accountant at No. 84, Market Street, Manchester, and A. Jones, 84, Market Street, Manchester, Accounts and Statements, and certify they are correct, duly vouched, and in accordance with Deeds and other Securities belonging to the Society, in respect of each of the 146 properties in

H. BROWN }
A. JONES } Auditors.

STATEMENT SHOWING THE OPERATIONS OF THE YEAR.

Balances at beginning of year as shown by last annual statement.	£	s.	d.	Additions during the year. Particulars.	Amount. £	s.	d.	Diminutions during the year. Particulars.	Amount. £	s.	d.	Balances at end of year as shown by Liabilities and Assets Account.	£	s.	d.
Due to shareholders . .	94,973	15	0	Subscriptions of shareholders, C.B.	12,241	19	10	Withdrawals of shareholders, C.B.	15,463	8	9	Due to shareholders . .	99,862	14	9
				Interest added, P. and L. . .	2,492	7	0	Interest paid, C.B.	3,807	0	11				
				Pref. shares, C.B.	13,400	0	0	Pref. shares, C.B.	4,130	0	0				
				Interest on ,, ,, P. and L. . .	1,124	19	7	Interest on ,, ,,	969	17	0				
				New deposits . .		—		Deposits withdrawn, C.B. . .	5,215	0	0				
Due to depositors and other creditors . . .	40,360	11	1	Interest added on deposits, P. and L.	1,302	2	1	Interest paid . .	1,392	12	5	Due to depositors and other creditors . . .	35,055	0	9
				Other additions, viz.—				Other diminutions, viz.—							
				Interest on mortgages, P. and L.	5,618	4	0	Bank commission, P. and L. . .	30	5	6				
				Interest on investments, P. and L.	600	0	0	Management expenses, P. and L.	530	18	4				
				Deductions on advances, P. and L.	590	15	0	Rent, rates, and taxes, P. and L.	287	4	4				
				Bank interest, P. and L.	21	18	11	Income tax, P. and L.	91	5	8				
Undivided profit not including prospective interest . . .	6,894	2	2	Rules, fines, etc., P. and L. . .	20	10	3	Subscription to Building Societies Association, P. and L. . .	2	2	0	Undivided profit not including prospective interest. . .	7,889	0	2
				Deductions on investment shares and deposits, P. and L.	5	1	4	Rules, P. and L. .		7	0				
								Interest on investments, P. and L.	2,492	7	0				
								Interest on pref. shares, P. and L.	1,124	19	7				
								Interest on deposits, P. and L.	1,302	2	1				
	142,228	8	3		37,417	18	0		36,839	10	7		142,806	15	8

Total . . £179,646 6*s.* 3*d.*
Note.—Items marked C.B. are taken from Cash Book.

Total . . £179,646 6*s.* 3*d.*
Items marked P. and L. are taken from Profit and Loss Account.

Balances at beginning of year as shown by last annual statement.				Additions during the year.				Diminutions during the year.				Balances at end of year as shown by Liabilities and Assets Account.			
				Particulars.	Amount.			Particulars.	Amount.						
	£	s.	d.		£	s.	d.		£	s.	d.		£	s.	d.
Due on mortgage securities, not including prospective interest . .	123,838	12	0	Advanced on mortgage, C.B. .	35,794	4	0	Repayment of advances, C.B. . .	35,348	5	1	Due on mortgage securities not including prospective interest . . .	123,980	9	10
				Interest due from borrowers, P. and L.	5,618	4	0	Interest received from borrowers, C.B.	5,618	4	0				
								Income from properties in possession, C.B. . .	304	1	1				
				Other additions, viz.—				Other diminutions, viz.—							
Other assets .	18,389	16	3	Bank Account, C.B. . . .	436	16	7	Rules, P. and L. .		7	0	Other assets .	18,826	5	10
	142,228	8	3		41,849	4	7		41,270	17	2		142,806	15	8

Total . . £184,077 12*s.* 10*d.*

Total . . £184,077 12s. 10*d.*

Note.—Items marked C.B. are taken from Cash Book.

Items marked P. and L. are taken from Profit and Loss Account.

Gas Companies

The accounts are in the form prescribed by the Gas Works Clauses Act, 1871.

The accounts are kept on the Double Account System.

The Revenue Account should be studied; the classification of expenditure being very clearly made.

The accounts of Water Companies follow a similar form with minor alterations to suit the particular circumstances.

The accounts of Electric Lighting Companies are made up in a specially prescribed form, but the form only differs from the accounts of Gas Companies in minor details, *e.g.* the total of the Capital, Receipts, and Expenditure is shown in the Balance Sheet instead of the difference.

DEVONSHIRE GAS COMPANY.

CAPITAL ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1912.

	Expenditure to 31st December, 1911.	Expended this year.	Total to 31st December, 1912.		Certified receipts, 31st December, 1911.	Received during year.	Total receipts, 31st December, 1912.
	£	£	£		£	£	£
To lands acquired, including law charges	33,500	—	33,500	By ordinary shares of £10 each	50,000	—	50,000
,, new buildings, manufacturing plant, machines, storage works and other structures connected with manufacture	45,700	600	46,300	,, preference shares of £10 each	40,000	—	40,000
				,, debenture stock	40,000	—	40,000
,, new mains and service pipes (not being in place of old ones) including laying same, paving, and other works connected with distribution	37,900	3,700	41,600	,, mortgages and bonds	10,300	5,000	15,300
,, new meters (not in place of old ones) including fixing	10,750	450	11,200				
,, cost of promoting special Act	1,000	—	1,000				
Total expenditure £	128,850	4,750	133,600				
To balance of Capital Account			11,700				
		£	145,300	Total		£	145,300

Dr. REVENUE ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1912. Cr.

	£	£
To manufacture of gas—		
Coals including dues, carriage, unloading, and all expenses of depositing same on works	8,850	
Purifying materials, oil, water, and sundries at works	150	
Wages at works	4,070	
Salaries of engineers, superintendents and officers at works	1,300	
Repairs and maintenance of plant and machinery	6,110	
		20,480
To distribution of gas—		
Salaries of surveyor and inspectors	450	
Repairs, renewals, and maintenance of mains, service pipes, etc.	1,050	
Repairing, renewing, and refixing meters	1,100	
		2,600
To public lamps—		
Lighting and repairing		600
To rents, rates and taxes—		
Rents	480	
Rates and taxes	200	
		680
To management—		
Directors' salaries	300	
Salaries of secretary and clerks	600	
Stationery and printing	210	
General establishment charges and incidentals	50	
Auditor	30	
		1,190
To bad debts—		50
Balance carried to Profit and Loss Account		5,900
		31,500

	£	£
By sale of gas—		
Common gas	18,500	
Public lighting and other contracts	7,500	
		26,000
Rental of meters		150
By residual products—		
Coke, less labour and cartage	4,110	
Breeze	130	
Tar	710	
Ammoniacal liquor	310	
		5,260
By rents		90
		31,500

PROFIT AND LOSS ACCOUNT (NET REVENUE) FOR THE YEAR ENDED 31ST DECEMBER, 1912.

Dr.	£	£		£	£ Cr.
To interest on mortgage bonds accrued to December 31st, 1912		500	By balance of net profit brought from last accounts, December 31st, 1911 .	4,600	
,, interest on debenture stock accrued to December 31st, 1912		1,600	*Less* dividends paid for half-year ended December 31st, 1911	2,250	2,350
,, half-year's dividend on preference shares to June 30th, 1912 . . .	1,000		,, balance brought from Revenue Account being profit for year to December 31st, 1912		5,900
,, half-year's dividend on ordinary shares to June 30th, 1912 . . .	1,250	2,250			
,, balance net profit to be carried to next account, subject to half-year's dividends to December 31st, 1912		3,900			
£		8,250	£		8,250

GENERAL BALANCE SHEET ON 31ST DECEMBER, 1912.

Dr. | Cr.

Dr.	£	Cr.	£	£
To Capital Account—		By cash at Bankers		3,100
Balance to credit thereof	11,700	,, coals for stock on hand, 31st December, 1912	2,800	
,, Profit and Loss Account—		,, coke and breeze, 31st December, 1912 .	50	
Balance to credit thereof	3,900	,, tar and other products, 31st December, 1912	170	
Interest accrued and unpaid on mortgages, bonds and debenture stock to 31st December, 1912	1,100	,, sundry stores, 31st December, 1912 . .	1,380	4,400
Sundry tradesmen and others for amount due for coals, stores, etc., to 31st December, 1912	2,200	,, gas meter rental : balance of this account due to the company on 31st December, 1912, less deposits and prepayments .	2,700	
,, Wages and contingencies—		,, coke and other residuals, 31st December, 1912	2,500	
Amount due to 31st December, 1912 .	100	,, sundry accounts, 31st December, 1912 .	6,300	11,500
£	19,000	£		19,000

HOSPITALS

The form given is an abridgment of the official form prescribed for institutions receiving grants from the King Edward VII. Hospital Saturday and Sunday Funds.

The Expenditure is required in considerable detail with a view of ascertaining whether there is any waste or extravagance.

It should be noted that the figures are required for three years for purposes of comparison.

Name of Hospital ____________________

INCOME AND EXPENDITURE FOR THE YEAR ENDING DECEMBER 31, 1913.

Income.	Receipts for year 1911.	Receipts for year 1912.	Receipts for year 1913.	Expenditure.	Analysis. Hospital.	Analysis. Nurses.	Expenditure for year 1911.	Expenditure for year 1912.	Expenditure for year 1913.
A. Ordinary—				A. Maintenance—	£ s. d.	£ s. d.			
i. Annnal subscriptions . . .				i. Provisions (detailed)					
ii. Donations . . .				ii. Surgery dispensary (detailed) . .	(In-patients)	(Out-patients)			
Boxes . . .				iii. Domestic (detailed)					
iii. Hospital Sunday Fund . . .				iv. Establishment charges (detailed)					
iv. Hospital Saturday Fund . . .				v. Rent					
v. Invested property:				vi. Salaries (detailed) .					
Dividends . .				vii. Miscellaneous expenses (detailed).					
Income tax returned . . .				B. Administration—					
Rents . . .				i. Management (detailed) . . .					
vi. Nursing institution				ii. Finance					
vii. Patients' payments									
viii. Other receipts .				Total ordinary expenditure					
Total ordinary income				C. Extraordinary—					
B. Extraordinary—				i. Repairs					
Legacies				ii. Building improvements . . .					
				Total extraordinary expenditure . .					

Railway Companies

The form of Accounts is taken from the Railway Companies (Accounts and Returns) Act, 1911.

It will be noted that the previous year's figures are required for comparison in the Revenue Accounts (Statements 8 and 9), and that the usual Debit and Credit form of such Accounts has been forsaken.

Detailed Statements are required in respect of the Receipts and Expenditure in each department of the undertaking, in addition to the information given in Statement No. 8.

The Receipts and Expenditure Account and General Balance Sheet call for no special comment, being made up on the Double Account System in the usual style.

STATEMENT No. 4.

THE X Y Z RAILWAY COMPANY.

RECEIPTS AND EXPENDITURE ON CAPITAL ACCOUNT.

Expenditure.	Expenditure to December 31st, 1912.	Expended during the year.	Expenditure to date.	Receipts.	Receipts to December 31st, 1912.	Received during the year.	Received to date.
	£	£	£		£	£	£
Lines open for traffic	6,280,000	125,000	6,405,000	Shares and stock .	7,000,000	—	7,000,000
Lines not open for traffic—				Debenture stocks .	1,000,000	—	1,000,000
New Lines	27,000	19,000	46,000	Premiums on shares			
Widening existing lines . . .	8,200	7,800	16,000	and stocks . .	120,000	—	120,000
Lines leased	130,700	300	131,000				
Rolling stock	760,600	32,400	793,000	Total receipts .	8,120,000	—	8,120,000
Manufacturing and repairing works and plant—							
Land and buildings	25,000	—	25,000				
Plant and machinery	27,800	1,200	29,000				
Total capital expended on railway .	7,259,300	185,700	7,445,000				
Horses	6,700	200	6,900	Excess of expenditure over receipts carried to General			
Road vehicles employed in collection and delivery of parcels, goods and passengers—				Balance Sheet .	335,800	205,200	541,000
1. Goods and parcels road vehicles	3,100	100	3,200				
2. Passenger road vehicles . .	1,700	200	1,900				
Steamboats	255,000	2,000	257,000				
Canals	582,000	7,000	589,000				
Docks, harbours and wharves . . .	63,000	2,000	65,000				
Hotels	235,000	8,000	243,000				
Subscriptions to other railways . .	50,000	—	50,000				
Total expenditure . . . £	8,455,800	205,200	8,661,000	£	8,455,800	205,200	8,661,000

STATEMENT NO. 8.

THE X Y Z RAILWAY COMPANY.

REVENUE AND EXPENDITURE ACCOUNT FOR THE YEAR ENDING DECEMBER 31ST, 1913.

				Year, 1912.		
	Gross receipts.	Expenditure.	Net receipts.	Gross receipts.	Expenditure.	Net receipts.
	£	£	£	£	£	£
Railway	1,056,200	682,000	374,200	*1,005,000*	*637,800*	*367,200*
Omnibuses	3,280	2,700	580	*2,170*	*2,080*	*90*
Steamboats	75,800	52,680	23,120	*74,700*	*51,890*	*22,810*
Canals	112,750	89,500	23,250	*119,800*	*90,670*	*29,130*
Docks, etc.	11,880	9,230	2,650	*11,920*	*9,150*	*2,770*
Hotels, refreshment and dining cars	76,700	55,200	21,500	*68,800*	*53,300*	*15,500*
	1,336,610	897,310	445,300	*1,282,390*	*844,890*	*437,500*
Miscellaneous receipts—						
Rents from houses and land			22,000			*20,230*
Interest and dividends from investments in other companies—						
A B Railway Co.			1,000			*1,000*
C D Railway Co.			1,000			*1,000*
Transfer fees			20			*30*
General Interest			380			*240*
Total net income			470,000			*460,000*

STATEMENT NO. 9.

Proposed Appropriation of Total Net Income.

			Year, 1912.	
	£	£		£
Balance brought forward from last accounts		92,000		*88,000*
Net income from statement No. 8		470,000		*460,000*
Total		562,000		*548,000*
Deduct—Chief rents	17,000		*16,000*	
Interest on £1,000,000 4 % Debenture Stock	40,000	57,000	*40,000*	*56,000*
Balance after payment of fixed charges		505,000		*492,000*
Appropriation to reserve		100,000		*100,000*
		405,000		*392,000*
Dividends on Guaranteed and Preference Stock		100,000		*100,000*
Balance available for dividend on Ordinary Stock		305,000		*292,000*
Dividends on Ordinary Stock		200,000		*200,000*
Balance carried forward		105,000		*92,000*

STATEMENT No. 18.

THE X Y Z RAILWAY COMPANY.

Dr. GENERAL BALANCE SHEET, DECEMBER 31ST, 1913. Cr.

	£		£
To amount due to railway companies and committees	16,700	By Capital Account, balance to debit thereof	541,000
,, Savings Bank	125,600	,, Cash at Bankers and in hand	425,000
,, Superannuation Fund	222,000	,, Investments in stocks and shares held by the company and not charged as capital expenditure	18,000
,, Accounts payable	469,700	,, Stock of stores and materials	427,000
,, Insurance Fund	200,000	,, Outstanding traffic accounts	285,000
,, Depreciation Funds—		,, Amounts due by railway companies	17,000
Railway	142,000	,, Amounts due by railway clearing-houses	11,000
Steamboats	8,000	,, Amount due by Postmaster-General	3,000
,, General Reserve	200,000	,, Accounts receivable	62,000
,, Balance of Revenue Account available for dividend	405,000		
	1,789,000		1,789,000

EXAMINATION PAPERS

INSTITUTE OF CHARTERED ACCOUNTANTS

INTERMEDIATE, NOVEMBER, 1911

Time allowance, 2 hours.

Q. 1.—Describe your process of auditing a statement to be presented to the shareholders of a private company at the first (statutory) meeting. You find that the ordinary shares had all been issued to the vendor as fully-paid, and the preference shares had all been subscribed for by the directors and paid up by cash in full.

Q. 2.—What evidence would you require as to the existence and ownership of the following assets :—

Lease of gold mining rights,
Patent rights,
Freehold property in England, mortgaged,
Foreign Bonds,
Consols held by two directors on behalf of the Company ?

Q. 3.—A company insured for its own benefit the life of the managing director for £10,000, at an annual premium of £250. How would you expect the outlay to be dealt with in the accounts submitted to you for audit ?

Q. 4.—In the Balance Sheet of a company submitted to you for audit you find, amongst others, the following items :—

	£
Creditors in London (Head Office)	10,000
Due to Manchester Branch	2,000
Due to Glasgow Branch	1,000
	£13,000

	£
Debtors in London (Head Office)	15,000
Due from Liverpool Branch	3,000
Due from Birmingham Branch	1,800
Due from Belfast Branch	200
	£20,000

What adjustments, if any, would you require before certifying?

Q. 5.—For what payments through a banking account would you accept endorsed cheques as adequate vouchers?

Q. 6.—On September 30th, 1911, a tin-plate manufacturing company contracted to buy 100 tons of tin at £169 per ton, for delivery December 31st, 1911. A few days later they contracted to sell 100 tons at £171 10*s*., also for delivery December 31st, 1911. The accounts are made up to October 31st, 1911, and you find that Profit and Loss has been credited with £250 in respect of these transactions. Would you pass the item as correct? If not, state your views.

Q. 7.—What special features would you expect to find in auditing the accounts of a company owning either a newspaper, or a fleet of steamships, or trading as a motor bus company? Set out your procedure in any one of such instances.

Q. 8.—Have you any views as to the manner in which bank cheques might be so designed as to make them perfect vouchers, in the majority of cases, for payments? If so, state them.

Q. 9.—Criticise the following Balance Sheet:—

THE STONE BUILDING CONSTRUCTION COMPANY, LIMITED.

Balance Sheet for the year ended June 30th, 1911.

Liabilities.	£	*s.*	*d.*	£	*s.*	*d.*
Ordinary Share Capital				100,000	0	0
Preference Share Capital, 5½ per cent.				100,000	0	0
Debenture Stock, £100,000, issued at £95				95,000	0	0
Depreciation of Plant and Machinery				2,500	0	0
Creditors, Bills payable, Bank overdraft, etc.				83,547	0	0
Profit and Loss, Balance at June 30, 1910	2,726	0	0			
Profit for the year	12,141	0	0			
	14,867	0	0			
Less Preference Dividend	5,500	0	0			
	9,367	0	0			
Less proposed Ordinary Dividend	6,000	0	0			
				3,367	0	0
				£384,414	0	0

Assets.	£ s. d.	£ s. d.
Goodwill, Patent Rights, etc., at cost .	154,510 0 0	
Patent fees, etc., paid during the year .	162 0 0	
		154,672 0 0
Unpaid calls on Preference Shares . .		17,500 0 0
Plant and machinery at cost		45,482 0 0
Stocks on hand at cost		24,418 0 0
Contracts not completed and work in progress	170,728 0 0	
Estimated profit thereon, 15 per cent. .	25,609 0 0	
	196,337 0 0	
Less received on account	130,000 0 0	
		56,337 0 0
Debtors for completed contracts, etc. .		73,791 0 0
Petty Cash in hand		2,214 0 0
		£374,414 0 0

Signed by two directors on behalf of the Board, and certified by A. B. & Co., acting as auditors.

Q. 10.—Assuming the following facts, and that the board of a cigarette manufacturing company declined to amend the figures of the Balance Sheet presented to you for audit, what observations, if any, would you make thereon in your "Report to the Shareholders"?

The subscribed Capital was £50,000, all called up, but £10,000 thereof was represented by "Calls in Arrear," all due from directors.

The "Stock of Tobacco" was valued at the market price at the date of the Balance Sheet, but was in excess of the actual cost.

No reference was made to "Bills under Discount."

Final, November, 1911

Auditing

Time allowance, 2 hours.

Q. 1.—Compare the audit work for a small manufacturing limited company, having a staff consisting of a manager (who also acts as secretary), a cashier, and two junior clerks, with the audit work for a large manufacturing limited company, employing a managing director, secretary, chief accountant, works manager, and a well-organised staff of fifty clerks. Give your reasons for differences (if any) of procedure in the respective audits.

Q. 2.—The directors of a manufacturing limited company insist on

drawing a considerably larger sum for remuneration than they are entitled to, and one of their number, with the formal consent of his co-directors, borrows a substantial sum of money from the company for his own convenience. Is it necessary for the auditor to make any reference to either of these matters in his report to the shareholders, if the accounts issued to the shareholders disclose the amount of fees drawn by the directors, and also disclose the fact that the loan is made to a director? What difference would it make to the auditor's action if the facts as regards the loan were not disclosed on the face of the accounts? Give your reasons for your replies.

Q. 3.—What items would you expect to find under the heading of "Contingent Liabilities" in the Balance Sheet of a limited company carrying on the business of railway and dock contractors? How would you ascertain the existence of such liabilities?

Q. 4.—What rights of investigation has an auditor of a limited company under the Companies (Consolidation) Act, 1908? What does the Act require him to report on, and to whom does he report? What specific statements must be made in the report? Who are entitled to see the report, and in what way can they do so?

Q. 5.—In the annual Balance Sheet of a limited company the creditors were understated, in consequence of goods purchased not having been brought into the Purchase Day Book and Ledger, though the goods were included in the stock. Could an auditor, under such circumstances, be held responsible for not discovering the omissions? Give your reasons for your reply. What checks can an auditor apply to avoid such errors?

Q. 6.—Extensive thefts are committed in the wages or cash sales of an undertaking, and they are not discovered by the auditor. Under what circumstances, if any, can the auditor be held responsible, in the event of the subsequent discovery of the thefts?

Q. 7.—A limited company (whose annual accounts are made up to the end of December in each year) on the 30th June buys a business as at the date of its last Balance Sheet, tbe previous 31st March. How would you deal with the profits of this business in the annual accounts of the company? Give your reasons for the course you would adopt.

Q. 8.—Suggest an explanation of the fact that goodwill may be entered in the annual Balance Sheet at its cost price, irrespective of fluctuations in its value since its purchase, and without any necessity for an auditor to draw attention to the difference between the Balance Sheet value of goodwill and its market value. If such divergence between facts and figures is permissible with goodwill, why is it not equally permissible with all other assets in Balance Sheet?

Q. 9.—Give a short account of how an auditor should satisfy himself as to the adequacy of a reserve for bad and doubtful debts, discount, and

allowances. Describe some of the chief difficulties and pitfalls he may meet with in the work.

Q. 10.—Discuss the question whether an auditor of a limited company should challenge an under-valuation of assets just as much as over-valuation, assuming *bona fides* and also *mala fides*.

Intermediate, May, 1912

Auditing

Q. 1.—Describe your method of auditing the Wages Books of a manufacturer. Describe what tests you would apply on every occasion, and what (if any) you would apply from time to time.

Q. 2.—Give your views upon the value of Counterfoil Receipts in an audit. Instance an undertaking in which you consider them desirable, and state what conditions must be fulfilled to render them an effective check upon the cash received.

Q. 3.—Doubts having arisen as to the accuracy of the Share Books of a public company, describe in detail the steps you would take to audit them.

Q. 4.—What is meant by the following terms :—

(*a*) "Contingent Liability."

(*b*) "Collateral Security?"

Give two examples of each, showing (with the context) how you would enter them in the Balance Sheet of firm or company.

Q. 5.—How would you verify the correctness both as to quantity and value of *any two* of the following :—

(*a*) Pig Iron and Mineral Stocks of a Blast Furnace Co.

(*b*) Raw Cotton and Yarn Stocks of a Cotton Spinning Mill.

(*c*) Coal Stocks of a Coal Merchant.

(*d*) Inscribed Stocks of a Public Institution.

(*e*) Copper in Bars in Warehouse.

Q. 6.—What evidence would you require for the verification (in the accounts of a limited company) of the following :—

(1) Authorised Capital,

(2) Additions to Machinery during the period under review,

(3) Directors' Remuneration,

(4) Value of Work in progress on Uncompleted Contracts,

(5) Depreciation of Leaseholds,

(6) Patent Rights?

Q. 7.—Give your views on the advantage of a concurrent (or consecutive) audit, as compared with a periodical one.

Q. 8.—Being asked by the Executors or Trustees of the estate of a deceased person to audit the accounts at the end of the first year; state what documents and papers you would require in addition to the Books of Accounts, and with what object, in each case.

Q. 9.—Describe fully your method of auditing a Cash Book having Cash, Bank, and Discount columns.

Q. 10.—Give a programme of an audit of a business with which you are familiar, describing the nature of the business without mentioning the name.

FINAL, MAY, 1912

AUDITING

Q. 1.—State very briefly the objects of an audit.

Q. 2.—In connection with the accounts of each of the following, select one distinguishing feature to which an Auditor's attention should be particularly directed:—

(1) Trust and Investment Company.
(2) Gas Company.
(3) Municipal Corporation (without any commercial undertakings).
(4) Building Society.
(5) Joint Stock Bank.

Elaborate your answer in relation to any two of the examples you select.

Q. 3.—It is proposed to amalgamate three manufacturing concerns of a kindred nature (private Limited Liability Companies) into a Public Company, the whole of the share capital of which is to be offered for public subscription. Your certificate is desired for the prospectus. With your instructions you are requested to certify the aggregate profits of the three concerns for the past five years, and to state an average. You find on examination that:—

(1) The charges for Repairs to Plant, whilst fairly uniform in each concern, are smaller in amount than in your experience is the rule in similar businesses.
(2) Depreciation of Plant has been written off annually at rates varying considerably in the three concerns.
(3) No provision for Bad and Doubtful Debts has been made in the last three years by the largest of the three concerns, which has earned no dividend upon its Ordinary Shares during that period.

In the absence of any satisfactory explanations on the points given above, draw the certificate you would propose giving in the circumstances, *without figures.*

Q. 4.—An Exporting House, with several foreign branches, receives the whole of its remittances for goods in the form of Bills, and discounts all that are not payable at sight.

As considerable time must necessarily elapse after the end of its financial year before the accounts are submitted to you for audit, what examination of the Bills Receivable Account would you institute, and what steps would you take, to verify the items in its Balance Sheet, "Bills Receivable in hand" and "Bills under Discount"?

Q. 5.—In the annual accounts of a Limited Liability Company submitted to you for audit, the following items appear in the Profit and Loss Account:—

(1) Profit on Sale of Land £750 (a proportion of £1000, proceeds of sale of land adjoining an hotel, which, with the land, had been purchased at auction during the year for £10,000).

(2) Profit on Share Account, £1000 (made up of £250 dividends received on 1000 shares of £1 each, fully paid, held in five Cinematograph Companies, standing in the books at £2000; and £750 proceeds of sale of 1000 bonus shares of £1 each, allotted as fully paid to the Company on its holding in three of the above Companies, upon their amalgamation just prior to the close of the year).

What suggestions would you make with regard to the treatment of the above, and, if your suggestions were disregarded, what would be your duty as Auditor?

Q. 6.—What do you understand by the term "internal check"? Illustrate by giving details of its application in a business with which you are acquainted, stating the nature of the business.

Q. 7.—In a retail business, doing a large trade, the checking by the auditor of the whole of the invoices for goods purchased is considered unnecessary. What means would you employ to satisfy yourself (1) that the credits passed to Bought Ledger Accounts are in order, and (2) that the amount due to Sundry Creditors as stated in the Balance Sheet is correct?

Q. 8.—A Public Company was formed by the amalgamation of several businesses. Two years after its formation, in consequence of the fact that one of the businesses was unprofitable, an investigation was made into the books of that business for a period prior to its acquisition by the Company, with the result that they were found to be false and fraudulent. The Vendor of that business, who was one of the Directors of the new Company, resigned his position on the Board, and in 1909 surrendered 5000 shares in the Company of £1 each, fully paid, to a nominee of the Directors for the benefit of the Company. The assets of the business in question, which, with its goodwill, were standing in the books of the new

Company at cost, viz. £10,000, were sold in 1910 for £3000. The surrendered shares were sold by the Company in 1911 at par.

How should these transactions be referred to in the Company's annual accounts in each of the three years?

Q. 9.—In the Balance Sheet of a Wholesale Business, with several retail branches, which is submitted to you for audit, you find the following:—

	£
Stock and Book Debts (Head Office)	25,000
Do. do. (Branches)	12,500
	37,500
Deduct Reserve for Bad and Doubtful Debts	600
	£36,900

What is your duty with regard to the verification of these items? How would you desire them stated?

Q. 10.—A., the Chairman and Managing Director of a Public Company, to which you are the appointed Auditor, holds half the Ordinary Share capital of the Company.

To increase the profits sufficiently to enable the Directors to declare a dividend on the Ordinary Shares, A. waived his right to remuneration for the year (fixed by the Articles of Association at £1000), which had already been paid to him. He also caused certain debts due to the Company, incurred in the ordinary course of its trading, which had proved to be irrecoverable, to be written off to his private account. A.'s account in the General Ledger, as the result of the above arrangements, stood in debit of the amount of £3000, for which sum A. lodged satisfactory security with the Company. All these matters received the approval of A.'s co-Directors, and were properly entered in their minutes.

What, in these circumstances, is your duty to the shareholders, and why?

Intermediate, November, 1912

Auditing

Q. 1.—In an audit where it is impossible to check the postings of the personal accounts in detail, describe what system you would adopt to satisfy yourself as to the correctness of the amounts appearing in the Balance Sheet for Trade Debtors and Trade Creditors.

Q. 2.—The Bookkeeper of a Company is appointed Secretary, at a remuneration of £200 per annum. He is also appointed a Director. How would you satisfy yourself that his remuneration is in order?

Q. 3.—Describe what steps you would take to satisfy yourself as Auditor as to the correctness of the Stock-in-Trade as appearing in the Balance Sheet of a Manufacturer.

Q. 4.—How would you check the Credit Sales Day Book of an Iron Merchant?

Q. 5.—You are instructed to audit the books of a Trust Estate, the Testator having died on the 30th June, 1910, and you find the following entries in the year ended 30th June, 1912:—

		£	
(1) Trustees' Remuneration . . .		500	debited to Capital Account.
(2) Rents of Leasehold Property . .		300	credited to Income Account.
(3) Gold Mining Venture, Ltd.—Dividend of 100 per cent. for year ended 31st Dec., 1911 .		500	Ditto.
(4) Trading Stores, Ltd.—Dividend on 6 per cent. Cumulative Preference Shares for 4 years ended 30th June, 1912 .		240	Ditto.
(5) Investment on Mortgage	£1,150		
Interest unpaid for 2 years to 31st Dec., 1911	100		
		1,250	
Mortgage foreclosed and Property realised on 31st Dec., 1911 .		1,000	
Loss		£250	debited to Capital Account.

What inquiries would you make, and what adjustments, if any, are necessary in respect of any three of these items? Omit any reference to Income-Tax.

Q. 6.—As the Auditor of a Shipping Company, how would you verify the following items?

Freight of 2,000 tons of coal, Cardiff to Malta at 10*s*. 6*d*. per ton	£1,050
Freight on general cargo loaded by owners	2,325
Insurance on hull—	
Lloyd's Underwriters—premiums	300
Mutual Marine Association—Premiums and calls . .	50
Recovered from Underwriters, for general average . . .	250
Light Dues	5

The Ledger Balances of the same Company include the following :—

	Dr. £	s.	d.	Cr. £	s.	d.
Current Voyages—						
Rose, Voyage 10	1,550	6	3			
Violet, Voyage 3	2,310	7	6			
Primrose, Voyage 6				1,350	7	11
Damage Account—						
Pansy	1,560	0	0			

How would you verify these balances, and how should they be stated in the Balance Sheet?

Q. 7.—The Trial Balances of a Company at 30th June, 1912, are as follows :—

		Dr. £	Cr. £
Capital Account—			
40,000 shares of £1 each			40,000
Sundry Creditors			10,000
Provision for Bad Debts Account			500
Bankers			5,000
Profit and Loss Account			2,500
Call Account—			
5*s*. per share on 8,000 shares		2,000	
Sundry Debtors		30,000	
J. Jones, Director		1,000	
Goods on sale or return at selling prices		6,000	
Investments—			
5,000 shares of £1 each with 10*s*. per share paid *cost*		3,250	
Stock at selling price		10,000	
Plant and Machinery as per last Balance Sheet	£5,000		
Additions since	500		
		5,500	
Cash in hand		250	
		£58,000	58,000

Note.—The Bankers are secured by an issue of Debentures for £5,000.

The Market value of the Investment at 30th June, 1912, is 5*s*. per share.

The Directors have had the following Balance Sheet prepared, which they refuse to alter, and ask you, as Auditor, to sign. In their report they recommend the payment of a dividend of 6 per cent.

BALANCE SHEET AT 30TH JUNE, 1912.

Capital and Liabilities.	£	*Assets.*	£
Capital—		Plant and Machinery . .	5,500
40,000 shares of £1 each	40,000	Investment at cost . . .	3,250
Sundry creditors . . .	10,500	Stock	10,000
Bankers	5,000	Sundry debtors	39,000
Profit and Loss Account .	2,500	Cash in hand	250
	£58,000		£58,000

State what points you would refer to in your report as Auditor.

Q. 8.—A. and B., a firm of Surveyors, ask you to audit their books at the end of the first year of the partnership. On arriving at the office you find the only books of account are :—

(1) Press Copy Book, into which the Debit Notes for Fees are copied. The press copies are marked as paid, and dated as and when the Fees are received.

(2) Petty Cash Book, in which the weekly Salaries of the Staff and all smaller expenses are entered.

(3) Bank Pass Book, all payments other than petty cash being made by cheque.

The Partnership Deed is produced to you, and it appears therefrom—

(*a*) A. brought into the business various assets and the connection at the agreed value of £600.

(*b*) B. brought in £500 in cash.

(*c*) The profits are to be divided equally.

(*d*) The partners are entitled to draw on account of profits : A. £6 per week, B. £5 per week, and they have, in fact, drawn these respective amounts by cheques.

Under these circumstances, how would you audit the accounts for the past year, and what books would you advise the firm to keep in future?

Q. 9.—The Manager of a Manufacturing Concern, of which you are Auditor, is paid partly by salary and partly by commission. Under the agreement for service, in case of dispute as to the commission payable, the Auditor's decision is to be final.

Such a dispute has arisen, and in order that your decision may be wholly unbiased, the Profit and Loss figures are given to you, without any indication as to which are the items in dispute. Following are the figures supplied, and you are asked to prepare and certify statements showing :—

(*a*) The manufacturing profit.

(*b*) The percentage of net profit to the manufacturing cost.

	Dr.	Cr.
	£	£
Stock at 1st January, 1911	1,500	
Purchases	2,000	
Manufacturing Wages and Salaries	2,000	
Office Salaries	410	
Discount on Sales	150	
Carriage Inwards	100	
Carriage Outwards	120	
Printing and Stationery	70	
Rents and Rates	390	
Travelling Expenses	130	
General Expenses	290	
Discount on Purchases		100
Sales		6,000
Stock at 31st December, 1911		1,800
	£7,160	7,900

In answering this question, the detail must be shown.

Q. 10.—X. is the Manager of several Companies, whose books and accounts he keeps, there being the same Auditor for each Company. The following are summaries of the Cash Books of two of the Companies, which have separate Bank Accounts under the Manager's control.

A. B. C. COMPANY, LTD.

1912.		£	1912.		£
Jan. 31	Sundry receipts	2,000	Jan. 31	Sundry disbursements	370
,, 31	Cash from bank	370	Feb. 28	Ditto	100
Mar. 31	Sundry receipts	2,000	Mar. 31	Paid to bank	1,000
April 30	Cash from bank	400	May 31	Sundry disbursements	900
June 30	Sundry receipts	100	June 30	Ditto	300
			,, 30	Paid to Bank	2,200
		£4,870			£4,870

The financial year closes on 30th June.

X. Y. Z. COMPANY, LTD.

1912.		£	1912.		£
Feb. 28	Sundry receipts	500	Feb. 21	Sundry disbursements	500
Mar. 31	Ditto	1,000	Mar. 31	Ditto	400
April 30	Cash from bank	400	,, 31	Paid to Bank	1,000
May 31	Sundry receipts	2,000	May 31	Sundry disbursements	900
June 30	Ditto	500	June 30	Ditto	1,000
,, 30	Cash from bank	2,200	July 31	Paid to Bank	3,100
July 31	Sundry receipts	300			
		£6,900			£6,900

The financial year closes on 31st July.

Is there anything disclosed upon which you would consider it the duty of the Auditor to specially report?

FINAL, NOVEMBER, 1912

AUDITING

Q. 1.—The Balance Sheet of a Dock and Harbour Company submitted to you for audit shows Interest during construction paid out of Capital to Preference Shareholders, and treated as a capital outlay. Under what conditions (if at all) could this be legally done, and, if not, why not? Give your answer in full, with particulars of the sections of the Acts of Parliament governing your reply.

Q. 2.—To what special points would you direct attention in the audit of any three of the following four undertakings? Explain fully your reasons:—

(1) Electric Lighting Company working under Provisional Order.

(2) Savings Bank.

(3) Coal Mine.

(4) Wholesale Home Trade Warehouse.

Q. 3.—Set out your programme for the audit of a Land and Mortgage Company, transacting its business in the United States, but having its registered office in England. Describe an arrangement of accounts satisfactory to you in the absence of any audit on the other side, and draw up a form of report to the Shareholders upon the Balance Sheet. Explain how the question of Rates of Exchange should be dealt with, both in regard to fixed Assets and Current Accounts.

Q. 4.—What do you understand by the term "internal check"? Has an Auditor any responsibility in regard thereto? Show by illustration under what circumstances, and to what extent, if any, he is justified in relying upon it in the course of an audit.

Q. 5.—What are the duties of an Auditor in regard to underwriting commission paid in connection with an issue of Shares and Debentures? Under what conditions may such underwriting commission be paid, and how does it differ from brokerage?

Q. 6.—Define the responsibility resting upon an Auditor in regard to proving the correctness of the following items in the course of an audit. Give illustrations (within your own knowledge, if possible) of the danger-points to be safeguarded:—

Manufactured Stocks.
Invested Funds.
Land and Buildings.
Cash Balance.
Cheques issued and outstanding.

Q. 7.—In the Balance Sheet of a firm of Coal, Iron, and Mineral Merchants you find the following entry :—

By Railway Wagon Account £2500

On inquiry, you find that this is a nominal sum to represent generally the firm's interest in its wagons, and that it employs 300, of which 100 are owned by the firm, 100 are on simple repairing lease for a term of years, and the remaining 100 are held on hire purchase for a term of years, of which about half has expired.

Criticise the above item, and state what evidence you would require regarding the wagons and how you would advise the firm's interest therein should preferably be stated in the Balance Sheet, and what information on the subject of the wagons and their running you would expect to find in the firm's books.

Q. 8.—Criticise the following statement in the form of Balance Sheet attached to the Annual Return of a Company submitted to you as Auditor for signature, before being sent to Somerset House. To what date should such statement be made up? When may it be dispensed with?

BALANCE SHEET, JUNE 30TH, 1912.

		£		£
To Share Capital issued— 100,000 Shares of £1 each		100,000	By Lands, Buildings, Plant, Goodwill and Trade Marks	120,000
To Debenture Stock . .		50,000	By Debtor Balances . .	30,000
To Credit Balance and Reserve Funds . .		25,000	By Stock	14,000
To Profit & Loss Account at 30/6/11 .	£2,500		By Cash at Bank and Sundry Investments . .	17,500
To Profit for year	9,000			
	11,500			
Less Dividend paid	5,000			
		6,500		
		£181,500		£181,500

Q. 9.—A firm of Rural Contractors, who also sell implements, tools, and articles of that nature, to farms and country houses, present the following Balance Sheet for you to audit, preparatory to an interview with their Bankers, from whom they desire further accommodation :

BALANCE SHEET, 30TH JUNE, 1912.

	£	£		£
To Creditors . . .	3,240		By Stock (valued by J. Smith, valuer) . . .	3,685
To Bills Payable .	2,000		By Premises, Plant, and Loose Assets . . .	2,360
		5,240	By Land Account . . .	300
To Provision for Periodical Payments, &c. . . .		760	By Book Debts	4,862
To Provision for Bad Debts		900		
To Bank Overdraft . . .		200		
Capital Account at 1/7/11 . . .	4,000			
Int. 12 mos. . . .	200			
	4,200			
Drawings	500			
	3,700			
Profit	400			
		4,100		
		£11,200		£11,207

There are two partners in the firm, who are brothers, and have never had any deed of partnership or division of capital, and each has drawn similar sums from the business and at the same time.

Upon examining the Trial Balance with the Balance Sheet you find the Book Debts apparently understated in the Balance Sheet by £400, but you find among the list of balances, but not in the Balance Sheet, a Credit Suspense item of like amount, and you are told that this is intended to meet two bad contracts which are included in the Book Debts as good balances. You also find among the Credit Balances another suspense item of £200, which you are told is intended as a provision to meet expected losses on several small contracts, and you discover that this item has been included in the Balance Sheet under the heading "Provision for Periodical Payments, etc."

The error of £7 in the Balance Sheet appears to have come forward from previous years.

The amount on the credit side called "Land Account" you find to be a deposit paid in respect of a purchase of land for £3000, which is due for completion in the following week.

Criticise and correct the Balance Sheet where needful, and append such a Certificate and Report as seem to be called for, having regard to the object for which the Balance Sheet is required.

Q. 10.—A firm of Sewing Machine Manufacturers, being overstocked, has consigned 300 machines to an agent in Mexico. A *pro formâ* invoice at £5 each has been sent by same mail, and the agent is instructed to sell at $50 per machine (or as near thereto as he can, but not below $40), on the assumption that the dollar is worth 2*s*.

A three months' Bill for £750 has been sent through the Bankers of the firm for acceptance by the agent, and, after being duly accepted, has been retained by them as collateral security for the firm's general account, which is in debit.

That is the position at the date of the Balance Sheet, and the item appears therein at the *pro formâ* invoice price, and there is no mention of the bill.

During the audit, account sales arrive from the agent showing that he has sold two lots of 100 machines each, one lot at $50 per machine and one at $45 per machine, leaving 100 machines still on the hands of the agent. The agent advises that he has bought sterling bills at 30 days to remit in respect of the first 100 machines at 1*s*. 11¾*d*., and in respect of the second lot at 2*s*. 1½*d*., both of which are, so far as required, to be applied to meet his acceptance, which is maturing shortly.

The following questions arise :—

(*a*) How, in your judgment, ought the transaction to be expressed in the Balance Sheet?

(*b*) In what way does the question of Exchange affect the business?

Full answers to both questions are desired, but the figures are not intended to be worked out.

FINAL, MAY, 1913

AUDITING

Q. 1.—What do you understand by the expression "Fixed and Circulating Capital," and to what extent may an Auditor distinguish between them? State any legal decision bearing on the subject.

Q. 2.—You are appointed Auditor to a firm on the condition that you check the cash received as shown in the Cash Book with the counterfoils of Receipt Books and Bank Pass Book to the end of each month within the first half of the following month, also the vouchers for the payments, and at the close of each year prepare and submit a certified Profit and Lost Account and Balance Sheet. Set out fully the steps you would take to ensure your audit being an effective one.

Q. 3.—Under what circumstances would you as Auditor consider is necessary to insert special clauses in your report to shareholders of a Public

Company registered under the Companies (Consolidation) Act, 1908? Give three examples.

Q. 4.—In auditing the first annual Balance Sheet of a Company registered under the Companies (Consolidation) Act, 1908, you find the following items on the credit side :—

(1) Goodwill.
(2) Increase in value of investments.
(3) Commission on issue of Debentures.
(4) Preliminary expenses.
(5) Loss on Consignment Accounts.

The debit side shows a "Balance of Profit and Loss Account," and the Directors have informed you they intend to declare a dividend. Explain fully how you would propose to deal with each of the five items referred to when discussing the Balance Sheet at the next Board meeting which you have been requested to attend.

Q. 5.—You are instructed to audit the *Cost* Accounts of a firm of Builders in respect of work done by them on contracts which have been completed.

Explain shortly how you would do this.

Q. 6.—A manufacturing firm has a number of departments, and articles sold by the firm pass through several departments before being finally completed. The manager of each department receives, as part of his emoluments, a commission on the profits of his department. You are instructed as Auditor of the firm to certify the amount of commission to which each manager is entitled, and also the net profit of the firm for the past year. To what special points would you direct your attention?

Q. 7.—On receiving from the Secretary of a Company of which you are the Auditor the Balance Sheet, you find that during the year the Directors have issued £100,000 in 20,000 shares of £5 each at par and paid a commission thereon at 5*s*. per share ; and also £100,000 in 5 per cent. Debentures of £100 each at £98, paying a commission for placing same of £1 each Debenture. The Directors do not propose to charge any of the commission or discount against the Profit and Loss Account. How would you require the items dealt with in the Balance Sheet, so as to enable you to report without addition to the statutory requirements?

Q. 8.—You are instructed on behalf of the Residuary Legatee of a Testator whose estate consisted of investments in "gilt-edged Securities," Furniture, Pictures, and Works of Art, also money on deposit with various financial institutions, and on current account with Bankers. Bequests were made to relatives and charities. The Executors intimate to your client that they are prepared to pay over to him a certain sum, being the amount they state is the residue to which he is entitled. Draft the programme of your audit.

Q. 9.—Give the particulars of the audit of the accounts of a Members Club whose building is held on lease. The furniture, plate, linen, wine, cigars, etc., are the property of the Club, with the exception that some of the wines are the property of Wine Merchants, who are allowed to keep a stock in the cellars of the club, and are paid quarterly for the wine consumed, at the price it is sold to members, less a discount of 10 per cent.

Q. 10.—The following assets are in the Balance Sheet of an Insurance Company of which you are Auditor. How would you satisfy yourself as to their correctness?

(*a*) Loans on Company's Policies within their surrender value.
(*b*) Great Northern Railway Co. Ordinary Stock.
(*c*) Investments in Reversions.
(*d*) Agents' Balances.
(*e*) Outstanding Premiums.

INCORPORATED ACCOUNTANTS

Final Examination, June, 1912

Auditing

1. A manufacturing firm dealing with some 30,000 customers, all for small amounts, whose accounts are due for discount in a month, and net in three months, invites you to devise a system by which the due dates of these accounts can be carefully watched, and will at the same time provide an easy reference to dead accounts in order that they may, if possible, be revived. Give your recommendations.

2. Would you differentiate in certifying a Balance Sheet for a private client's own information, and in acting (say) as the nominee of a bank in the audit of a customer's accounts, and, if so, to what extent, and for what reasons?

3. Under what circumstances and to what extent would you feel justified as an Auditor in sanctioning the capitalisation of interest and other expenses during construction? Discuss shortly the aspects of the subject which occur to you.

4. A Company holds stock in trade which has fallen much below cost, and as Auditor you point out that it must be taken at the lower value. The Directors prove to you that this Stock was bought against sale contracts, and will in due course be used in the carrying out of these contracts, and will earn a normal profit over cost. Apart from the well-known rule, do you see any reason why in these special conditions the Stock should not be included in the accounts at cost? Give your reasons.

5. A Company seeks to charge to Capital Account items which are, in your view, Revenue Charges. It is, however, urged upon you that (1) as you are aware the depreciation of assets in previous years has been excessive, and thus a secret reserve has been created which can well bear these charges, and (2) to insist upon debiting them against Revenue will result in a loss which may seriously prejudice the Company. What would be your attitude as Auditor, and why?

6. In a private Company of which you are Auditor, the Managing Director (who is also the principal shareholder, and whose family controls the balance of the shares) tends to do irregular things and to resent as needless your request that all transactions shall be recorded on right lines. He credits as a loan from himself to the Company a sum of £5,000, which you have reason for knowing, from a source you cannot disclose, has been borrowed from an outsider upon an equitable deposit of the deeds of the Company's warehouse property. You call for the deeds and they are produced to you, having been borrowed for the purpose from the mortgagee. What do you conceive to be your duty in the circumstances?

7. A land company writes up in its books the value of its property which has admittedly increased in value, and credits the increment to Profit and Loss Account, though it has not been actually realised. It is proposed out of this and other profits to pay a dividend. Are you, as an Auditor, aware of any legal decisions which will guide you in determining your attitude towards this proposal? If this principle is once conceded, must it be continued?

8. Directors, in accordance with their powers, receive payment of calls in advance, and though no profits are made, proceed to pay interest upon such sums. Upon audit, this payment comes under your notice. Would you pass the item, and if so, why?

9. A Company issues Preference Shares at a premium upon the understanding that the premium is to form the remuneration of the underwriters, who agree to pay for all advertising, printing, etc. How would you advise that the premium and its disbursements should be treated in the books?

DECEMBER, 1912

AUDITING

1. The directors of a limited company of which you are Auditor have effected loans against the investments of the Company. State to what special points your attention should be directed in dealing with the liabilities thus created.

2. State your views shortly and concisely on the following propositions :

That an Auditor should actually value stock or that he should be authorised to employ a professional valuer to undertake the work.

3. The managers of a retail trading company require from you, as Auditors the most efficient check on its employés who handle money, and the best method of dealing with the records appertaining to it. Draw up a report to be submitted to the directors.

4. The following figures are from the Balance Sheet of a Company of which you are Auditor :—

Capital Account—

200,000 Ordinary Shares of £1 each,

200,000 Cumulative 5 per cent. Preference Shares of £1 each, the dividend on which at this date, December 31st, 1911, is two years and a half in arrear.

The Sundry Creditors amount to £22,000, and the Debtors to £80,000, after due reserve for bad and doubtful debts.

The properties and other assets of the Company are valued after depreciation at £400,000, and there is cash at the bank £23,002.

The Company has made a profit during 1911 of £90,198, but at December 31st, 1910, there was a debit balance of £40,400.

The Articles of Association provide that a sum equal to 10 per cent. of any dividend paid to the Ordinary shareholders and any surplus remaining after such dividend has been paid to them, shall be put to reserve until £50,000 is accumulated. This reserve appeared on the Balance Sheet of December 31st, 1910, at £31,204.

State your views and criticisms on the position as shown by the Balance Sheet, and also report as to the best way in your opinion of dealing with the profit earned during 1911.

5. What are the best tests that can be applied by an Auditor to verify—

(*a*) Cash in hand at branches.

(*b*) Interest due.

6. Is it possible for a system of Cost Accounting to be too rigid? Point out, in your opinion, how it may tend to defeat its object.

7. When sales are made with the provision that certain discounts are to be allowed if payment is made on or before certain dates, would you, when auditing the accounts, make provision for such discounts on outstanding accounts? Give reasons.

8. Describe generally what care should be exercised and what work done by an Auditor to verify the accuracy of the wages sheets of a factory.

9. In auditing the accounts of a Company what special circumstances would suggest an inspection and review of the initial entries relating to the Company's formation at a date prior to that covered by the immediate audit?

JUNE, 1913

AUDITING

1. In dealing with the Costing Accounts of a business, what do you understand by "Indirect Expenses"? Assuming that some contracts involve little raw material and much labour, and other contracts involve much material and little labour, how would you propose to distribute the "Indirect Expenses"? Give reasons.

If the profits are much less than anticipated, what steps would you, as auditor, take in reference to the system of costing?

2. There is reason to suspect a heavy leakage of goods from a firm of wholesale smallware manufacturers. Devise as complete a check as you can to prevent losses from such a source.

3. When a testator's estate is sufficient to pay the debts, but not the legacies in full, in what order should the assets be applied?

4. The Balance Sheet of a firm contains amongst its assets a considerable item for Patents—some actually taken out by the firm, and others bought from patentees at a premium. You find that the amount is built up of the cost of the Patents and maintenance expenses, and that nothing has been written off. Write a careful report giving your recommendations.

5. In investigating the Accounts of a Club or Hotel, where there is a considerable consumption of wines and liqueurs, you find that in some years there has been no adequate return for the outlay, and in other years the return has been very variable. Make a careful statement as to the steps that you would take in the investigation.

6. How would you recommend the following items to be dealt with in the Accounts:—

(*a*) Patterns in a Cloth Merchant's Office.

(*b*) Models in a Foundry Account.

(*c*) Partner's Life Insurance Policies in a Partnership Account.

(*d*) Leasehold Property.

Give an example of your treatment of each.

7. What do you understand by the term "Secret Reserves"? Does the term altogether convey a just impression? If such reserves had been created by (*a*) under valuation of premises; (*b*) over-depreciation of plant, what would be your attitude, as Auditor, towards them?

8. A sells to B on the Hire-Purchase system, for £450, goods which he would have sold for cash for £400, the agreement providing for the payment of £112 10*s*. 0*d*., at the end of each of four years. The £50 difference between the Hire-Purchase and Cash-down price is approximately the charge for interest at 5 per cent., on the goods, the exact figure being being £51 4*s*. 4*d*.

Give your view as to the method in which these transactions should be recorded in the vendor's books.

9. You are asked to devise as simple a method as possible to enable a firm to check its bank interest. Exemplify your method by ascertaining the rate allowed for credit balances in the following account, where it is known that the charge for overdraft is five per cent.:—

J. B. in account with the Northern Banking Co. On April 1st the balance to the credit of J. B. was £250. J. B. paid in £850, £170, £200 and £650 on April 17th, May 20th, June 13th, and July 3rd respectively; and drew out £400, £1070, £500 and £400 on May 11th, June 4th, June 19th, and July 30th respectively. The total net sum allowed for Interest to August 31st was 12*s*. 11*d*. only.

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THE END

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